[JOINT COMMITTEE PRINT]

DESCRIPTION AND ANALYSIS OF TAX PROPOSALS RELATING TO SAVINGS AND INVESTMENT (CAPITAL GAINS, IRAs, AND ESTATE AND GIFT TAX)

SCHEDULED FOR A PUBLIC HEARING

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON MARCH 19, 1997

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on March 19, 1997, on savings and investment provisions in the President's fiscal year 1998 budget proposal [1] relating to capital gains, IRAs, and the estate and gift tax and broad-based alternatives.[2] This pamphlet,[3] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of tax proposals relating to capital gains and losses, IRAs and other retirement savings incentives, and estate and gift taxation.

Part I of the pamphlet is a summary. Part II is a description and analysis of proposals relating to capital gains and losses. Part III is a description and analysis of proposals relating to IRAs and other retirement savings incentives, and Part IV is a description and analysis of proposals relating to estate and gift taxation.

[1] See Department of the Treasury, *General Explanation of the Administration's Revenue Proposals, February 1997*. Also, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998*.

[2] Broad-based alternatives to the President's budget proposal include proposals to replace the Federal income tax. For a description and analysis of such proposals, including the possible effects on saving and investment, see Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS-18-95), June 5, 1995.

[3] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Savings and Investment (Capital Gains, IRAs, and Estate and Gift Tax)* (JCS-5-97), March 18, 1997

I. SUMMARY

A. Capital Gains and Losses

1. Present Law

Generally, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain is taxed as ordinary income, except that the net capital gain of noncorporate taxpayers is subject to a maximum marginal rate of 28 percent. Capital losses are generally deductible in full against capital gains. In addition, in the case of noncorporate taxpayers, such losses may be deducted against ordinary income, up to a maximum of $3,000 in each year. Noncorporate taxpayers can carry forward capital losses in excess of these limitations to future years indefinitely, but may not carry back the losses to prior years. Corporate taxpayers generally may carry back capital losses three years and forward five years.

A "capital asset" generally means any property held by the taxpayer except for the following specified classes: (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications.

The Revenue Reconciliation Act of 1993 provided a 50-percent exclusion for gain from the sale of stock in certain corporations that was acquired at original issuance when the corporation had aggregate gross assets of not more than $50 million and was held for more than five years. One-half of the excluded gain is a minimum tax preference.

No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time. An individual, on a one-time basis, may exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale, and (2) has owned the property and used it as a principal residence for three or more of the five years preceding the sale. A loss on the sale or exchange of a principal residence is treated as a nondeductible personal loss.

2. Legislative Background

Noncorporate capital gains were taxable at reduced rates from 1921 through 1987. The system of capital gains taxation in effect prior to the Tax Reform Act of 1986 dated largely from the Revenue Act of 1942 ("1942 Act"). The 1942 Act provided for a 50-percent exclusion for noncorporate capital gains or losses on property held for more than six months. The 1942 Act also included alternative maximum rates on capital gains taxes for noncorporate and corporate taxpayers. The basic structure of the 1942 Act was retained under the Internal Revenue Code of 1954.

The Revenue Act of 1978 ("1978 Act") increased the exclusion for noncorporate long-term capital gains from 50 to 60 percent and repealed the alternative maximum rate. The reduction in the maximum individual rate from 70 to 50 percent under the Economic Recovery Tax Act of 1981 ("1981 Act") reduced the maximum effective capital gains rate from 28 percent to 20 percent. The Tax Reform Act of 1986 ("1986 Act") repealed the provisions granting reduced rates for capital gains, fully effective beginning in 1988. The 1986 Act provided that the maximum rate on capital gains (i.e., 28 percent) would not be increased in the event the top individual rate was increased by a subsequent public law (unless that law specifically increased the capital gains tax rate). The Revenue Reconciliation Act of 1990 ("1990 Act") raised the maximum individual rate to 31 percent, and the Revenue Reconciliation Act of 1993 ("1993 Act") raised the top tax rate to 39.6 percent. Neither the 1990 Act nor the 1993 Act raised the maximum individual capital gains rate.

The Internal Revenue Code of 1954 as originally enacted provided for an alternative tax rate of 25 percent on corporate capital gains. The Tax Reform Act of 1969 raised this rate to 30 percent. The 1978 Act reduced the alternative rate to 28 percent. The 1986 Act repealed the alternative rate.

3. Summary of Proposals

a. The "Capital Gains Tax Reduction Act of 1997" (H.R. 14) (Mr. Dreier and others)

The bill would provide individuals with a maximum capital gains rate of 14 percent. The 50-percent exclusion for gain from small business stock would be repealed. The bill would provide corporations with an alternative capital gains rate of 28 percent. In addition, the bill would provide individuals an inflation adjustment for purposes of determining gain or loss.

The provisions generally would apply to dispositions of assets after December 31, 1996.

b. The "Enterprise Capital Formation Act of 1997" (H.R. 420) (Mr. Matsui and Mr. English)

The bill would amend the rules relating to gain on certain small business stock by (1) increasing the exclusion to 75 percent, (2) reducing the holding period from five to three years, (3) making corporations eligible for the exclusion, (4) repealing the minimum tax preference, (5) increasing the maximum size of the corporation to $100 million, adjusted for inflation, (6) repealing the $10-million per issuer limitation, (7) amending the working capital and redemption rules, (8) allowing certain additional businesses to be a qualified small business, and (9) allowing taxpayers to rollover gain from the sale or exchange of small business stock to purchase other qualifying small business stock.

The provisions generally would apply to stock issued after August 10, 1993. However, the provisions relating to the holding period, corporate shareholders, and the size of the business generally would apply to stock issued after the date of enactment. The rollover provision would apply to stock issued after date of enactment.

c. The "Return Capital To The American People Act" (H.R. 1033) (Ms. Dunn and others)

The bill would allow all taxpayers a deduction equal to 50 percent of net capital gain for the taxable year. The bill also would repeal the present-law maximum 28-percent rate. Thus, the effective rate on the net capital gain of an individual in the highest rate bracket would be 19.8 percent, and the effective rate for a corporation in the highest corporate rate bracket (35 percent) would be 17.5 percent.

The bill would amend the rules relating to gain on certain small business stock in a manner similar to H.R. 420. The bill would provide for the rollover of gain on certain small business stock in a manner similar to H.R. 420.

The bill would index the basis of certain assets for inflation for the purpose of determining gain or loss in a manner similar to that provided in H.R. 14, but also would provide the indexing to corporate as well as individual taxpayers.

The bill would provide that a loss from the sale or exchange of a principal residence would be treated as a deductible capital loss.

The provisions relating to the deduction for gain and loss on a principal residence generally would apply to dispositions after December 31, 1996. The indexing provision would apply to dispositions of property the holding period of which begins after December 31, 1996. The bill would permit certain assets to be marked to market to establish a new holding period. The provisions relating to small business stock generally would apply to stock issued after August 10, 1993. The rollover provision would apply to stock issued after date of enactment.

d. Exclusion of Capital Gains on Sale of Principal Residence (The President's Fiscal Year 1998 Budget Proposal)

A taxpayer generally would be able to exclude up to $250,000 ($500,000 if married filing a joint return) of capital gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, a taxpayer must have owned a residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange of the residence.

The proposal would be available for all sales or exchanges of a principal residence occurring on or after January 1, 1997, and would replace the present-law rollover and one-time exclusion provisions applicable to principal residences.

e. "American Family Tax Relief Act" (S. 2) (Senator Roth and others)

The bill would allow individual taxpayers a deduction equal to 50 percent of net capital gain for the taxable year. The bill also would repeal the present-law maximum 28-percent rate. Thus, the effective rate on the net capital gain of an individual in the highest rate bracket would be 19.8 percent. Like H.R. 14, the bill would provide corporations with an alternative capital gains rate of 28 percent. The bill would modify the rules relating to gain on certain small business stock in a manner similar to H.R. 420, but unlike H.R. 420 would not provide for the rollover of gain on certain stock. The bill would provide individuals an inflation adjustment, in a manner similar to H.R. 14, but only for purposes of determining gain. Like H.R. 1033, the bill would provide that a loss from the sale or exchange of a principal residence would be treated as a deductible capital loss.

The effective dates of the provisions generally are the same as those provided by H.R. 1033.

4. Analysis of Issues

a. Background

In 1994, among individual taxpayers who filed Form 1040, Schedule D, 11 million taxpayers recognized $168 billion in long-term capital gains and 3.5 million taxpayers recognized $23.2 billion in short-term capital gains. In addition, 5.8 million taxpayers reported $8.5 billion of capital gain distributions, generally received from mutual funds. Taxpayers also reported $78.2 billion of long-term capital losses on 6.5 million returns and $47.5 billion in short-term losses on 3.6 million returns. Because gain recognition by taxpayers is elective, many analysts believe that capital gains recognized by taxable persons represent a fraction of the gains accrued by taxable persons annually.

b. Preferential rate for capital gains

Many argue that higher income tax rates discourage sales of assets. Preferential tax rates on capital gains impose a smaller tax on redirecting monies from older investments to projects with better prospects, which contributes to a more efficient allocation of capital. A second argument for preferential capital gains tax rates is that they encourage investors to buy corporate stock, and especially encourage investors to provide venture capital for new companies, thereby stimulating investment in productive business activities. Others argue that the capital gains preference may be an inefficient mechanism to promote the desired capital formation. They argue that a preferential capital gains tax rate, broadly applied, is not targeted toward any particular type of equity investment.

The United States has a relatively low rate of household saving, currently less than 5 percent of disposable income. By reducing the tax on realized capital gains, the after-tax return to household saving is increased. Economic evidence is ambiguous on whether, and in what magnitude, household saving responds to changes in the after-tax rate of return.

Proponents of a reduction in capital gain tax rates observe that many of our major trading partners have lower marginal tax rates on the realization of capital gains than does the United States. Opponents of a capital gains preference argue that the fact that marginal tax rates on capital gains are higher in the United States than in other countries does not imply automatically that American firms are at a competitive disadvantage. Preferential capital gains treatment on a disposition of corporate stock might be viewed as ameliorating the double taxation of corporate earnings. The first step of double taxation occurs at the corporate level; the second step occurs at the shareholder level as dividends are paid or as shares that have increased in value (presumably by retained earnings) are sold. However, any relief that a capital gains preference provides from the burden of double taxation applies only to retained corporate earnings. Distributed earnings still would be generally subject to double taxation.

Opponents of a reduced tax on capital gains argue that appreciating assets already enjoy a tax benefit from the deferral of tax on accrued appreciation until the asset is sold, which benefit reduces in whole or in part any bunching or inflationary effects. Proponents of a preference for capital gains contend that the benefit of deferral is insufficient to make up for more than very modest inflation. Moreover, they note that not taxing accrued appreciation is an inherent aspect of a realization-based tax system.

To the extent that preferential rates may encourage investments in stock, opponents have argued that the preference tilts investment decisions toward assets that offer a return in the form of asset appreciation rather than current income such as dividends or interest. On the other hand, it is argued that asset neutrality is not an appropriate goal because risky investments that produce a high proportion of their income in the form of capital gains may provide a social benefit not adequately recognized by investors in the marketplace.

Opponents of the preferential capital gains rate contend that it also encourages taxpayers to enter transactions designed to convert ordinary income to capital gains. On the other hand, it is argued that such "conversion" opportunities are simply an additional tax incentive for types of investments the capital gains preference is intended to encourage.

c. Issues relating to indexing

Proponents of indexing contend that indexing would accomplish the goals of reduced capital gains taxation while producing a more accurate measurement of economic income with greater neutrality. Opponents contend that indexing is complex and that it would not be necessary if efforts to control inflation are successful.

d. Capital gains and losses on owner-occupied housing

Critics of present law note that the disparate taxation of gain depending upon the disposition of proceeds or age of the taxpayer may distort taxpayer choice leading to inefficient outcomes. They observe that little revenue is collected on the sale of principal residences, so the efficiency losses to the economy are made in exchange for relatively little revenue gain. Proponents of permitting taxpayers to claim as capital loss any loss realized on the sale of their principal residence argue that because capital gains on a sale or exchange of a principal residence are taxable, losses on similar sales or exchanges should be treated as capital losses. As such losses represent a reduction in the taxpayer's wealth, it is also argued that the losses should be taken into account by the tax system to provide a better measure of economic income.

Opponents of such changes counter that owner-occupied housing already is tax-favored. Some opponents believe that the favorable treatment accorded owner-occupied housing under present law has distorted aggregate investment towards housing and away from plant and equipment.

e. Distributional effects of a reduction in capital gains

Either an exclusion from income or indexing the basis of capital assets will benefit directly those taxpayers who hold assets with accrued capital gains. Information is somewhat scant regarding the distribution of assets with accrued capital gains among different taxpayers. Tax return data contain information on which taxpayers have realized capital gains in the past. These data reveal that many taxpayers realize a capital gain from time to time, but the majority of the dollar value of gains realized are by taxpayers who frequently realize capital gains.

B. Individual Retirement Arrangements ("IRAs")

1. Present Law and Legislative Background

Present law and legislative background of IRAs

Under present law, under certain circumstances, an individual is allowed to deduct contributions up to the lesser of $2,000 or 100 percent of the individual's compensation (or earned income) to an individual retirement arrangement ("IRA"). Contributions of up to $2,000 can be made to an IRA for each spouse (including a nonworking spouse) as long as the combined adjusted gross income ("AGI") of the couple is at least equal to the amount contributed. The amounts held in an IRA, including earnings on contributions, generally are not included in taxable income until withdrawn.

The $2,000 deduction limit is phased out over certain AGI levels if the individual or the individual's spouse is an active participant in an employer-sponsored retirement plan. The phaseout is between $25,000 and $35,000 of AGI for single taxpayers and between $40,000 and $50,000 of AGI for married taxpayers. The phaseout of the deduction limit does not apply if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan.

An individual may make nondeductible contributions (up to the $2,000 or 100 percent of compensation limit) to an IRA to the extent the individual is not permitted to make deductible IRA contributions. Nondeductible contributions provide the same tax benefits as deferred annuities, that is, earnings are not includible in income until withdrawn. However, deferred annuities are not subject to contribution limits.

Distributions from IRAs are generally includible in income when withdrawn. Distributions prior to death, disability, attainment of age 59½ are generally subject to an additional 10-percent tax. The 10-percent tax does not apply to distributions (1) made in the form of an annuity, (2) for medical expenses for the individual or his or her spouse or dependents in excess of 7.5 percent of AGI, or (3) for medical insurance for certain unemployed individuals (and their spouses and dependents).

The IRA provisions were originally enacted in the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA, an individual was permitted to make deductible IRA contributions only if the individual was not an active participant in an employer-sponsored retirement plan. The limit on IRA deductions was the lesser of $1,500 or 15 percent of compensation (or earned income).

The Economic Recovery Tax Act of 1981 increased the IRA deduction limit to its current level and removed the restriction on IRA contributions by individuals who were active participants in employer-sponsored plans. The IRA rules in their current form were enacted as part of the Tax Reform Act of 1986. The Small Business Job Protection Act of 1996 modified the IRA provisions to allow certain nonworking spouses to make larger deductible IRA contributions.

Tax-qualified retirement plans and cash or deferred arrangements

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though the contributions are not currently included in an employee's income. Contributions to a qualified plan are held in a tax-exempt trust.

The tax treatment of contributions under qualified plans is essentially the same as that of present-law IRAs. However, the limits on contributions to qualified plans are much higher than the IRA contribution limits, so that qualified plans provide for a greater accumulation of funds on a tax-favored basis. In return for greater tax benefits, qualified plans are subject to rules that do not apply to IRAs, such as nondiscrimination rules that ensure that a qualified plan benefits a broad group of employees and does not discriminate in favor of highly compensated employees.

Qualified plan benefits are generally subject to tax when received under rules similar to those that apply to IRA withdrawals. An additional exception to the 10-percent early withdrawal tax applies in the case of distributions to an employee who retires after age 55. The exception for distributions to pay for medical insurance for unemployed individuals does not apply to distributions from qualified plans.

A qualified cash or deferred arrangement is one type of qualified plan. In general, a cash or deferred arrangement is an arrangement under which an employee can elect to receive an amount in cash or have it contributed to a tax-qualified pension plan. Amounts that are contributed to the plan are not included in income until withdrawn from the plan. Qualified cash or deferred arrangements are subject to the rules applicable to qualified plans generally, and are also subject to additional rules, including special nondiscrimination rules.

The maximum annual amount that an employee can elect to have contributed to a cash or deferred arrangement is limited to $9,500 (for 1997). This dollar limit is indexed for inflation.

SIMPLE retirement plans

Under present law, certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan.[4] SIMPLE plans can be adopted by employers who employ 100 or fewer employees who received at least $5,000 in compensation during the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an IRA for each employee or part of a qualified cash or deferred arrangement ("401(k) plan").

A SIMPLE retirement plan allows employees to make elective contributions of up to $6,000 per year (indexed for inflation in $500 increments). The employer is required to match employee contributions under one of two alternative tests or make a nonelective contribution on behalf of each eligible employee.

Simplified employee pensions

In order to reduce unwanted administrative burdens on employers (particularly smaller employers), present law permits an employer to establish a simplified employee pension (SEP) for its employees. A SEP is an IRA. However, the same contribution limits that apply to qualified plans apply to SEPs, so that a SEP provides a greater opportunity for tax-favored saving than an individual IRA.

Other tax incentives for saving

The Internal Revenue Code contains a number of other provisions which permit individuals to save on a tax-favored basis. These include provisions relating to tax-sheltered annuities, annuity contracts, and life insurance.

2. Summary of Proposals

a. IRA Provisions Contained in the President's Fiscal Year 1998 Budget Proposal

In general, the President's budget proposal would: (1) increase the present-law income limits (in two steps) on deductible IRA contributions and increase the income phase-out range to $20,000 (so that, for married taxpayers in 1997, 1998, and 1999, the income phase-out range would be $70,000 to $90,000 of AGI, and $80,000 to $100,000 thereafter; and for single taxpayers in 1997, 1998, and 1999, the income phase-out range would be $45,000 to $65,000 of AGI, and $50,000 to $70,000 thereafter); (2) index the $2,000 IRA contribution limit and the income limits; (3) coordinate the IRA contribution limit with the elective deferral limit under qualified cash or deferred arrangements and certain other plans; (4) create nondeductible tax-free IRAs called "Special IRAs;" and (5) provide an exception from the 10-percent early withdrawal tax for IRA distributions used for higher education expenses, first-time homebuyer expenses, medical expenses (in excess of 7.5 percent of AGI) of the individual's child, grandchild, parent or grandparent regardless of whether such person is a dependent of the individual, and distributions for any reason to individuals who have been receiving unemployment compensation for at least 12 weeks. The proposal would also provide that IRA assets can be invested in qualified State tuition program instruments.

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[4] SIMPLE retirement plans were created in the Small Business Job Protection Act of 1996.

b. The "Savings and Investment Incentive Act of 1997" (H.R. 446) (Mr. Thomas and others)

The bill would increase the AGI limits applicable to deductible IRA contributions for active participants in 1997, 1998, 1999, and 2000. Thereafter, the bill would repeal the limits on IRA deductions for active participants in employer-sponsored retirement plans. In the case of married taxpayers filing a joint return, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $65,000 and $75,000; for 1998, $90,000 and $100,000; for 1999, $115,000 and $125,000; and for 2000, $140,000 and $150,000. In the case of single taxpayers, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $50,000 and $60,000; for 1998, $75,000 and $85,000; for 1999, $100,000 and $110,000; and for 2000, $125,000 and $135,000.

Under the bill, an individual would not be considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is such an active participant. Thus, the bill would permit a nonworking spouse to make a deductible IRA contribution of up to $2,000 without regard to the present-law income phaseouts.

The bill would index the $2,000 IRA contribution limit in multiples of $500 after 1997.

Under the bill, the definition of coins eligible for the present-law exception for IRA assets invested in collectibles would be amended.

The bill would permit taxpayers to make nondeductible contributions to new tax-free IRA Plus accounts.

The bill would permit withdrawals from an IRA or IRA Plus to be exempt from the 10-percent additional tax on early withdrawals (sec. 72(t)) if made (1) for a qualified first-time homebuyer; (2) in the event of long-term unemployment, for any reason; (3) for the post-secondary education expenses of the individual, the spouse of the individual, or a dependent child of the individual or the individual's spouse; and (4) in the case of distributions for medical purposes, for any child, grandchild, or ancestor of the individual or the individual's spouse regardless of whether they are dependents of the individual.

c. IRA Provisions in the Balanced Budget Act of 1995 (H.R. 2491, 104th Cong.)

The "Balanced Budget Act of 1995" ("BBA") would have (1) phased up the present-law income limits on IRA deductions until phase out was $100,000 to $120,000 for married taxpayers (in 2007) and $85,000 to $95,000 for individuals (in 2007) and indexed the income limits after 2007; (2) indexed the $2,000 contribution limit; (3) provided that an individual is not an active participant merely because his or her spouse is an active participant in an employer-sponsored retirement plan; (4) created nondeductible tax-free IRAs (called American Dream IRAs); and (5) provided an exception from the 10-percent early withdrawal tax for IRA distributions for higher education expenses, first-time homebuyer expenses, certain medical expenses, and long-term unemployment.

d. IRA Provisions of the "American Family Tax Relief Act" (S. 2) (Senator Roth and others)

S. 2 would increase the AGI limits applicable to deductible IRA contributions for active participants in 1997, 1998, 1999, and 2000. Thereafter, the bill would repeal the limits on IRA deductions for active participants in employer-sponsored retirement plans. In the case of married taxpayers filing a joint return, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $65,000 and $75,000; for 1998, $90,000 and $100,000; for 1999, $115,000 and $125,000; and for 2000, $140,000 and $150,000. In the case of single taxpayers, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $50,000 and $60,000; for 1998, $75,000 and $85,000; for 1999, $100,000 and $110,000; and for 2000, $125,000 and $135,000. The bill would provide that the IRA deduction limit for any individual is coordinated with the limit on elective deferrals under qualified cash or deferred arrangements and certain other plans. Thus, an individual's deductible contributions to an IRA and elective deferrals could not exceed the annual limit on elective deferrals.

Under the bill, an individual would not be considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is such an active participant. Thus, the bill would permit a nonworking spouse to make a deductible IRA contribution of up to $2,000 without regard to the present-law income phaseouts.

The bill would permit taxpayers to make nondeductible contributions to new tax-free IRA Plus accounts.

The bill would permit withdrawals from an IRA or an IRA Plus to be made income tax free and exempt from the 10-percent additional tax if made (1) for the business start-up expenses of the individual or the spouse of the individual; (2) in the event of long-term unemployment, for any reason; or (3) for the post-secondary education expenses of the individual, the spouse of the individual, or a dependent child of the individual or the individual's spouse.

3. Issues Related to IRAs and Saving

Economic analysis of IRAs generally

Deductible IRAs allow taxpayers to deduct IRA contributions from income in the year contributed and pay income tax on the contributions plus earnings when withdrawn. This treatment creates two potential tax benefits: (1) taxpayers effectively earn a tax-free rate of return on IRA investments and (2) the contributions may be taxed at a lower marginal tax rate than the taxpayer's marginal tax rate when the contributions were made because IRA contributions are not taxed until withdrawn, at which time the taxpayer may be retired.

S. 2, H.R. 446, the BBA and the President's proposal would all create a new type of nondeductible IRA, commonly referred to as a back-end IRA. Withdrawals from a back-end IRA would not be taxable if contributions are held in the back-end IRA for a certain period of time.

From an economic perspective, back-end IRAs receive tax treatment generally equivalent to deductible IRAs. Because the taxpayer does not deduct back-end IRA contributions from income and pays no tax when amounts are withdrawn, the taxpayer is never taxed on the income earned on the investment. Whether the deductible IRA and back-end IRA are in fact economically equivalent depends on the difference between the taxpayer's marginal tax rate in the year contributions are made and the marginal tax rate in the year IRA funds are withdrawn. When marginal tax rates decrease over time (because tax rates change generally or taxpayers fall into lower tax brackets), the deductible IRA is more advantageous than the back-end IRA because the deductible IRA permits taxpayers to defer payment of tax until tax rates are lower. When marginal tax rates increase over time, a back-end IRA is more advantageous.

Additional differences exist between the deductible and back-end IRAs in the proposals. First, because the dollar limit on contributions to both the deductible IRA and the back-end IRAs is $2,000, the $2,000 back-end IRA contribution limit effectively increases the amount of tax-free saving that can be invested relative to the deductible IRA. A back-end IRA permits a taxpayer to accumulate tax-free income on $2,000 of after-tax dollars, whereas a $2,000 investment in a deductible IRA (which has not yet been subject to tax) is equivalent to only $1,440 in after-tax dollars (assuming a 28-percent marginal tax rate).

Second, because the 10-percent additional income tax on early withdrawals generally applies to the back-end IRA only during the first 5 years after a contribution has been made to the IRA, in general, the benefits of the back-end IRA are greater than those of the deductible IRA for taxpayers who desire to invest funds in an IRA for a relatively short period of time. However, because of the five year holding period under the proposals, this advantage of the back-end IRA exists only until a taxpayer attains age 59½, after which time the deductible IRA becomes more beneficial to the short-term investor.

Present value of revenue cost of IRAs to the Federal Government

Assessing the cost (in the form of forgone tax receipts) to the Federal Government of IRAs may be more difficult than assessing the costs of other tax provisions because IRAs change not only the amount of tax collected, but also the timing of tax collections. Traditional budget score keeping accounts for the revenue effects of proposed legislation on a cash-flow basis; in other words, the effect of a provision on budget receipts for a fiscal period is estimated without regard to whether the provision will also affect budget receipts in a subsequent period. This method scores deductible IRAs as generating a larger revenue loss than back-end IRAs, because more of the revenue loss occurs in the earlier years. However, a present-value calculation demonstrates that the long-term cost to the Federal Government of deductible IRAs and back-end IRAs will be approximately equal, except for the effects of changes in tax rates generally or for specific taxpayers, and the difference in the effective contribution limits.

Providing a choice between a deductible IRA and a back-end IRA is likely to increase the overall cost of IRAs to the Federal Government as compared to the cost of either option alone if taxpayers make accurate judgments about their future tax rates. Taxpayers who have reason to believe that their tax rates will decline over time will be more likely to invest in the deductible IRA, and taxpayers who believe their tax rate will increase over time or who intend to invest for a relatively short period of time will generally choose the back-end IRA.

Effectiveness of IRAs at increasing saving

IRAs have a number of attributes that may affect a taxpayer's saving decision. First, investments in IRAs earn a higher after-tax rate of return than investments in other assets. Second, IRAs may provide an incentive for retirement saving, as opposed to other forms of saving. Third, deductible IRAs may provide a psychological incentive to save in the case of taxpayers who owe the Federal Government income tax in excess of the amounts withheld and estimated tax payments made during a year. Fourth, advertising of IRAs by banks and other financial institutions may influence decisions to save.

Deductible IRAs have been very popular with taxpayers. Contributions to IRAs increased significantly when eligibility restrictions were eliminated in 1982. At the peak in 1985, over $38 billion was contributed to IRAs; this represented almost 33 percent of personal saving for that year. However, there is no consensus within the economics profession as to the effect of the pre-1986 IRA rules on personal saving. Some economists believe that IRAs had no effect on overall personal saving (i.e., they believe that IRA contributors merely shifted savings from one vehicle to another. Other economists believe that IRAs increased personal saving. Still other economists believe that IRAs would have eventually increased saving if the universally available deductible IRA had not been significantly restricted by the Tax Reform Act of 1986.

In 1985, 17.8 percent of all eligible returns reported contributions to an IRA. Of the returns reporting contributions, most (71 percent) reported AGI below $50,000. However, high-income taxpayers contributed at a much higher rate than lower-income taxpayers—61.8 percent of eligible returns with AGI of $50,000 or above reported contributions to an IRA, while only 13.8 percent of eligible returns with AGI below $50,000 reported contributions.

Although research on the effectiveness of the pre-1986 IRA provisions may shed light on the potential of the proposal to increase saving, several differences should be noted. First, marginal tax rates for most taxpayers are lower than they were before 1987. Thus, the tax advantages of IRAs are less valuable now than they were before 1987. Second, the proposed IRAs permit penalty-free withdrawals under different circumstances than the pre-1986 IRAs. Third, the back-end IRAs permit penalty-free withdrawals after only five years. Fourth, the growth of employer-based 401(k) savings plans may alter the attractiveness of IRAs for many taxpayers. These differences may increase or decrease the effect of IRAs on saving.

Issues relating to tax incentives for saving

Goals of tax incentives for saving

Some argue that tax incentives for saving are appropriate because the income tax system penalizes saving by taxing the return to income that is saved. This can affect both the national saving rate, as well as the assets taxpayers accumulate for particular purposes. Tax incentives for saving could be designed to encourage saving for particular purposes or to increase national saving.

IRAs have historically been viewed as vehicles for retirement saving. However, IRAs can provide substantial benefits to taxpayers who are saving for nonretirement purposes. For example, if funds are held in an IRA long enough, the taxpayer will benefit from the IRA even after payment of the income tax and the 10-percent early withdrawal tax.

Role of saving in the national economy

National saving is important to the economy because of its relationship to investment. The sources for investment are national saving and foreign investment. Increased investment increases the capital stock, which leads to greater productivity, higher wages and salaries, and increases in a nation's standard of living. Because of the possibility of foreign investment in the United States, a low saving rate does not necessarily mean a low investment rate. However, when foreign saving finances domestic investment, the profits from such investment are transferred abroad.

Net national savings declined through most of the 1980's, and is lower than that of other countries. Investment has declined as well over this period; however, foreign investment has compensated for some of the decline in domestic saving.

Adequacy of retirement savings

Social Security is the largest source of retirement income (40 percent in 1992), followed by income from assets (21 percent in 1992), earnings (17 percent in 1992), and private and government employee pensions (19 percent in 1992). The adequacy of retirement income is commonly measured by the replacement rate, that is, the ratio of retirement income to income during working years.

Available data indicate that Social Security and pension benefits replace roughly 33 percent of career high earnings and 50 percent of earnings over the last five years of employment. When spousal benefits are taken into account, replacement rates are slightly higher as a percentage of final earnings, averaging 30 to 33 percent of highest earnings and 60 to 70 percent of earnings over the last five years. These replacement rates are higher for individuals who had lower earnings.

It is not clear what an appropriate replacement rate is. A rate lower than 100 percent may be adequate. For example, people may desire to have more income during working years because some of that income is saved for retirement. People may also have lower expenses in retirement; for example, they may no longer be making payments on a home. On the other hand, a replacement rate of 100 may be too low. For example, a retiree may face much higher medical expenses than a younger person.

Although coverage by employer pension plans and Social Security is expected to be higher for current workers than for current retirees, the saving rate of current workers is lower than the rate at which current retirees saved during their working lives. Also, it is possible that the need for retirement income is increasing over time because of increases in life expectancies, trends toward early retirement, and rapid rises in medical costs.

C. Estate and Gift Taxation

1. Present Law

Under present law, a unified estate and gift tax is imposed on lifetime transfers and transfers at death. A unified credit of $192,800 is provided against the estate and gift tax, which effectively exempts the first $600,000 in cumulative taxable transfers from tax. For transfers in excess of $600,000, estate and gift tax rates begin at 37 percent, and reach 55 percent on cumulative taxable transfers over $3 million. In addition, a 5-percent surtax is imposed upon cumulative taxable transfers between $10 million and $21,040,000, to phase out the benefits of the graduated rates and the unified credit (i.e., if a taxpayer has made cumulative taxable transfers exceeding $21,040,000, his or her average transfer tax rate is 55 percent). A taxpayer may exclude $10,000 of gifts made to any one donee during a calendar year. A marital deduction generally is permitted for the value of property transferred between spouses.

Generally, for Federal transfer tax purposes, the value of property is its fair market value. Under Code section 2032A, however, an executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value. Currently, the maximum reduction in the value of such real property resulting from an election under Code section 2032A is $750,000.

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes. A contribution will be treated as "exclusively for conservation purposes" only if the conservation purpose is protected in perpetuity.

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to any beneficiary in a generation more than one generation below that of the transferor. The generation-skipping transfer tax is imposed at a flat rate of 55 percent on cumulative generation-skipping transfers in excess of $1 million. Because both the generation-skipping transfer tax and the estate or gift tax can apply to the same transfer, the combined marginal tax rate on a generation-skipping transfer can be as high as 80 percent. Under the "predeceased parent exception", a direct skip transfer to a transferor's grandchild is not subject to the generation-skipping transfer tax if the child of the transferor who was the grandchild's parent is deceased at the time of the transfer.

In general, the estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate pays only interest for the first four years, followed by up to 10 annual installments of principal and interest. A special 4-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business.

2. Legislative Background

Federal death taxes in this country, for most of its history, were imposed primarily to finance wars or threat of war. The first Federal death tax in the United States was a stamp tax imposed in 1797. The first progressive estate tax (similar to that imposed under present law) was adopted in 1916. Estate tax rates have varied over the past 81 years, ranging from a 10-percent maximum rate in 1916 to a 77-percent maximum rate in 1941. The first gift tax was imposed in 1924. Although the gift tax was repealed in 1926, it was reinstated in 1932 and has continued ever since. In 1948, Congress provided the first marital deduction, allowing 50 percent of any property transferred to a spouse to be transferred on a tax-free basis.

In 1976, Congress substantially restructured the Federal transfer tax system, unifying the estate and gift taxes, and imposing the first generation-skipping transfer tax. Since that time, tax rates have been changed, and the scope of the taxes has been modified to close perceived loopholes and to provide relief in certain circumstances. In addition, in 1981, an unlimited marital deduction was adopted.

3. Summary of Proposals

a. President's Fiscal Year 1998 Budget Proposal

The President's budget proposal would make several modifications to the installment payment provisions of section 6166. The proposal would increase the amount of value in a closely held business that would be eligible for the special low interest rate, from $1,000,000 to $2,500,000. Interest paid on the deferred estate tax would not be deductible for estate or income tax purposes, but the 4-percent rate would be reduced to 2 percent, and the deferred estate tax on any value of a closely held business in excess of $2,500,000 would be subject to interest at a rate equal to 45 percent of the usual rate applicable to tax underpayments. The proposal also would expand the availability and benefits of the holding company exception. Finally, the proposal would authorize the Secretary of the Treasury to accept security arrangements in lieu of the special estate tax lien.

b. The "Balanced Budget Act of 1995" (H.R. 2491, 104th Cong.)

The BBA would have increased ratably the present-law unified estate and gift tax credit over a six-year period beginning in 1996, from an effective exemption of $600,000 to an effective exemption of $750,000. After 2001, the effective exemption amount of $750,000 would have been indexed annually for inflation. The BBA also would have indexed annually for inflation the $10,000 annual exclusion for gifts, the $750,000 ceiling on special use valuation, the $1,000,000 generation-skipping transfer tax exemption, and the $1,000,000 ceiling on the value of a closely-held business eligible for the special 4-percent interest rate, beginning in 2001.

The BBA would have provided special estate tax treatment for certain qualified "family-owned business interests" if such interests comprised more than 50 percent of a decedent's estate. Subject to certain requirements, the BBA would have excluded the first $1 million in value of qualified family-owned business interests from the decedent's estate and also would have excluded 50 percent of the value of qualified family-owned business interests between $1 million and $2.5 million.

The BBA would have provided that an executor could elect to exclude from the taxable estate 40 percent of the value of any land subject to certain qualified conservation easements. The 40-percent exclusion from estate taxes for land subject to a qualified conservation easement could only be taken to the extent that the value of such land, plus the value of qualified family-owned business interests that qualify for the reduction in estate taxes, did not exceed $5 million. If the value of the conservation easement is less than 30 percent of (1) the value of the land without the easement, reduced by (2) the value of any retained development rights, then the exclusion percentage would be reduced by two percentage points for each point that the above ratio falls below 30 percent.

The BBA would have expanded the generation-skipping transfer tax exception for transfers to individuals with deceased parents to apply also to transfers to collateral heirs, provided that the decedent had no living lineal descendants at the time of the transfer. In addition, the BBA would have extended the predeceased parent exception to taxable terminations and taxable distributions, provided that the parent of the relevant beneficiary was dead at the earliest time that the transfer (from which the beneficiary's interest in the property was established) was subject to estate or gift tax.

The BBA would have provided that the cash lease of specially-valued real property by a lineal descendant of the decedent to a member of the lineal descendant's family, who continues to operate the farm or closely held business, would not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c).

The BBA also would have made a number of estate and gift tax simplification changes.

c. H.R. 525 (Mr. Crane and others) and H.R. 902 (Mr. Cox and others)

These bills would repeal the Federal estate and gift tax and the Federal generation-skipping transfer tax for decedents dying, gifts made, and generation-skipping transfers occurring after the date of enactment.

d. The "Family Business Protection Act" (Mr. McCrery and others)

The proposal would increase ratably the present-law unified estate and gift tax credit over a five-year period beginning in 1997, from an effective exemption of $600,000 to an effective exemption of $1,000,000. The bill also would modify the existing estate and gift tax rate schedule.

The proposal would provide special estate tax treatment for certain qualified "family-owned business interests" if such interests comprised more than 50 percent of a decedent's estate. Subject to certain requirements, the proposal would exclude the first $1,500,000 in value of qualified family-owned business interests from the decedent's estate, and also would exclude 50 percent of the remaining value of qualified family-owned business interests. Beginning in 1998, the $1.5 million threshold would be indexed annually for inflation.

Beginning in 1997, the proposal would index annually the $750,000 maximum reduction in the value of real property qualifying for an election under section 2032A.

The proposal would provide that an executor could elect to exclude from the taxable estate the value of any land subject to certain qualified conservation easements, and would also (1) exclude a gift of land subject to a conservation easement from the Federal gift tax upon the same terms as pertain to the exclusion from estate taxes, (2) provide that the granting of a qualified conservation easement would not be treated as a disposition triggering the recapture provisions of section 2032A, and (3) allow a charitable deduction to taxpayers making a contribution of a permanent conservation easement on property where a mineral interest has been retained and surface mining is possible, but its probability is "so remote as to be negligible."

Finally, the proposal would allow an exemption from the estate tax for the value of certain qualified historic property that would otherwise be included in a decedent's gross estate.

e. The "American Family Tax Relief Act" (S. 2) (Senator Roth and others)

The bill would increase ratably the present-law unified estate and gift tax credit over an eight-year period beginning in 1997, from an effective exemption of $600,000 to an effective exemption of $1,000,000.

The bill would provide special estate tax treatment for certain qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate. Subject to certain requirements, the bill would exclude the first $1,500,000 in value of qualified family-owned business interests from the decedent's estate and would also exclude 50 percent of the remaining value of qualified family-owned business interests.

The bill would extend the period for which Federal estate tax installments could be made under section 6166 to a maximum period of 24 years. If the election were made, the estate would pay only interest for the first four years, followed by up to 20 annual installments of principal and interest. There would be no interest imposed on the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely held business.

4. Analysis of Issues

a. Scope of the estate and gift taxes

The percentage of decedents liable for the estate tax grew throughout the postwar era reaching a peak in the mid-1970s. The substantial revision to the estate tax in the mid-1970s [5] and subsequent further modifications in 1981 reduced the percentage of decedents liable for the estate tax to less than one percent in the late 1980s. Since that time, the percentage of decedents liable for the estate tax has gradually increased. This is the result of the interaction of three factors: a fixed nominal exemption; the effect of price inflation on asset values; and real economic growth.

Since 1993, estate and gift receipts have been averaging double digit rates of growth. The staff of the Joint Committee on Taxation projects both revenues from the transfer taxes and the percentage of decedents liable for estate tax will continue to grow over the next decade.

b. Comparison to transfer taxation in other countries

Among developed countries, an inheritance tax is more common than the type of estate tax that is imposed in the United States. Because the U.S. estate and gift tax exempts transfers between spouses, provides an effective additional exemption of $600,000 through the unified credit, and exempts $10,000 per donee, the United States may have a larger exemption (a larger zero-rate tax bracket) than many other developed countries. However, marginal tax rates on taxable transfers in the United States generally are greater than those in other countries.

c. Economic issues

Taxes on accumulated wealth are taxes on the stock of capital held by the taxpayer. As a tax on capital, issues similar to those that arise in analyzing any tax on the income from capital arise. Some economists believe that an individual's bequest motives are important to understanding saving behavior and aggregate capital accumulation. Others question the importance of the bequest motive in national capital formation. Regardless of any potential effect on aggregate saving, the transfer tax system may affect the composition of investment. In particular, some observers note that the transfer tax system may impose special cash flow burdens on small or family-owned businesses. Taxes on wealth transfer also may affect individuals' labor supply decisions. Some suggest that, in addition to their role in producing Federal revenue, the transfer taxes may help prevent an increase in the distribution of wealth. Analysts have been unable to quantify what role tax policy might have played in any changes in wealth distribution over the past 70 years.

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[5] See description of changes made to the estate tax in 1976 in Part I.C.2., above.

II. CAPITAL GAINS AND LOSSES

A. Present Law

In general

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset (sec. 1001).[6] On the sale or exchange of capital assets, the net capital gain is taxed as ordinary income, except that the net capital gain of noncorporate taxpayers is subject to a maximum marginal rate of 28 percent.

Net capital gain; holding period

Net capital gain is the excess of net long-term capital gain for the taxable year over the net short-term capital loss for the year (sec. 1222). Long-term capital gain is defined as gain from the sale or exchange of a capital asset held for more than one year.

Capital losses

Capital losses are generally deductible in full against capital gains (sec. 1211).[7] In addition, in the case of noncorporate taxpayers, such losses may be deducted against ordinary income, up to a maximum of $3,000 in each year. Noncorporate taxpayers can carry forward capital losses in excess of these limitations to future years indefinitely, but may not carry back the losses to prior years. Corporate taxpayers generally may carry back capital losses three years and forward five years (sec. 1212).

Capital assets

A "capital asset" generally means any property held by the taxpayer except for the following specified classes: (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications (sec. 1221).

Certain depreciable property, nondepreciable business property, and special assets

A special rule (sec. 1231) applies to gains and losses on the sale, exchange, or involuntary conversion of certain noncapital assets.

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[6] There are certain exceptions to this rule. For example, regulated futures contracts and certain other items must be "marked to market" as gain or loss accrues even though there has been no disposition of the asset.

[7] However, section 165 generally denies individuals a deduction for losses not incurred in a trade or business unless such losses are incurred in a transaction entered into for profit or qualify as deductible casualty losses. See also section 267 (disallowance of deduction for certain losses from sale or exchange of property between related persons) and section 1092 (limitation on current deductibility of losses in the case of straddles).

Net gains from such assets (in excess of depreciation recapture) are treated as long-term capital gains but net losses are treated as ordinary losses. However, net gain from such property is recharacterized as ordinary income to the extent net losses from such property in the previous five years were treated as ordinary losses. The assets eligible for this treatment include depreciable property or land held for more than one year and used in a trade or business (if not includible in inventory and not held primarily for sale to customers in the ordinary course of business), as well as certain special assets including timber, coal, domestic iron ore, certain livestock and certain unharvested crops.

Patents

Under certain circumstances, the holder of a patented invention may transfer his or her rights to the patent and treat amounts received as proceeds from the sale of a capital asset, whether or not the proceeds are contingent on the use or productivity of the patent (sec. 1235).

Regulated futures contracts

Under present law, unlike most assets (with respect to which no gain or loss is realized until a disposition), regulated futures contracts, foreign currency contracts, nonequity options and dealer equity options are "marked-to-market" as gain or loss accrues (sec. 1256). Forty percent of the gain or loss is treated as short-term gain or loss and 60 percent of the gain or loss is treated as long-term gain or loss. Individuals who have a net loss from such contracts may elect to carry the loss back three years against prior net gain from such contracts.

Gains on certain small business stock

The Revenue Reconciliation Act of 1993 provided a 50-percent exclusion for gain from the sale of stock in certain corporations that was acquired at original issuance when the corporation had aggregate gross assets of not more than $50 million and was held for more than five years. One-half of the excluded gain is a minimum tax preference. The amount of gain eligible for the 50-percent exclusion is limited to the greater of (1) 10 times the taxpayer's basis in the stock or (2) $10 million gain from stock in that corporation (sec. 1202).

Losses on small business stock

An individual may treat as an ordinary loss up to $50,000 ($100,000 in the case of a joint return) on the loss from the disposition of small business corporation stock originally issued to the individual (or to a partnership having the individual as a partner) (sec. 1244). A small business corporation is a corporation engaged in the active conduct of a trade or business whose equity capital does not exceed $1,000,000.

Certain foreign corporate stock

Special rules recharacterize as ordinary income a portion of gain on the sale or exchange of certain foreign corporate stock, in order to compensate for the deferral of U.S. tax on corporate earnings and profits accumulated abroad (secs. 1246, 1248).

Collapsible property

The distinction between capital gains and ordinary income has led to numerous attempts to realize the value of an anticipated future ordinary income stream through the sale of a "capital" asset, such as stock in a corporation, or an interest in a partnership, that holds the income-producing asset.

Present law contains statutory rules intended to prevent such use of partnerships and corporations to convert what otherwise would be ordinary income into capital gains from the disposition of stock or a partnership interest. These provisions (secs. 341 and 751) are known respectively as the "collapsible" corporation and "collapsible" partnership provisions.

Similarly, certain partnership rules relating to basis allocations (secs. 732 and 755) are intended to prevent conversion of ordinary income to capital gain by preventing allocations of basis from capital assets to ordinary income assets in certain partnership transactions.

Conversion transactions

The Revenue Reconciliation Act of 1993 provided that capital gain from the disposition of property that was part of a "conversion transaction" would be recharacterized as ordinary income, with certain specified limitations (sec. 1258).

In general, a "conversion transaction" is a transaction, generally consisting of two or more positions taken with regard to the same or similar property, where substantially all of the taxpayer's return is attributable to the time value of the taxpayer's net investment in the transaction. To be classified as a "conversion transaction," a transaction must also satisfy one of the following four criteria: (1) the transaction consists of the acquisition of property by the taxpayer and a substantially contemporaneous agreement to sell the same or substantially identical property in the future; (2) the transaction is a straddle, within the meaning of the straddle rules (sec. 1092); (3) the transaction is one that was marketed or sold to the taxpayer on the basis that it would have the economic characteristic of a loan but the interest-like return would be taxed as capital gain; or (4) the transaction is described as a conversion transaction in regulations promulgated the Treasury. (No such regulations have been issued.)

Recapture provisions

Depreciation recapture rules recharacterize as ordinary income a portion of gain upon dispositions of depreciable property. These rules vary with respect to the type of depreciable property. Under the modified accelerated cost recovery system ("MACRS"), for personal property, previously allowed depreciation (up to the amount of realized gain) is generally recaptured as ordinary income (sec. 1245). In the case of real property using the straight-line method of depreciation (the only method generally permitted for real property placed in service under MACRS), there is no depreciation recapture upon disposition if the asset is held for more than one year (sec. 1250). For real property to which the MACRS does not apply, generally, the excess of depreciation deductions over the straight-line method is recaptured as ordinary income. Special rules apply to certain non-residential property and to certain low-income housing.

Similar recapture rules apply to dispositions of oil, gas, geothermal or other mineral property. These rules require ordinary income recapture (up to the amount of realized gain) of previously deducted intangible drilling and development costs, mining expenses, and depletion (sec. 1254).

Nonrecognition transactions

Under various nonrecognition provisions, realized gains and losses in certain transactions are deferred for tax purposes. Examples of such nonrecognition transactions include certain corporate reorganizations, certain like-kind exchanges of property, and involuntary conversions followed by an acquisition of replacement property (secs. 361, 1031, and 1033). Generally, nonrecognition treatment defers gain or loss for tax purposes by providing a carryover basis from the old holder to the new holder or a substitution of basis from the old property to the new property.

In addition, the Revenue Reconciliation Act of 1993 permitted any corporation or individual to elect to roll over without payment of tax any capital gain realized upon the sale of publicly-traded securities where the corporation or individual uses the proceeds from the sale to purchase common stock or a partnership interest in a specialized small business investment company within 60 days of the sale of the securities (sec. 1044).

Capital gains on sale of principal residence

Rollover of gain.—No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of this gain rollover rule.

One-time exclusion.—In general, an individual, on a one-time basis, may exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale, and (2) has owned the property and used it as a principal residence for three or more of the five years preceding the sale (sec. 121).

Loss on sale of a principal residence.—A loss on the sale or exchange of a principal residence is treated as a nondeductible personal loss.

Investment interest limitations

The amount of investment interest that an individual may deduct in a taxable year is limited to the amount of net investment income for that year (sec. 163). Excess amounts of investment interest are carried forward. To the extent an individual elects to treat long-term capital gain as investment income for purposes of computing the investment interest limitation, that amount of net capital gain does not qualify for the maximum 28-percent rate (sec. 1(h)).

Basis step up at death

At death, income tax on unrealized capital gains on an individual taxpayer's assets is forgiven, due to the step up in basis such assets receive (sec. 1014).[8]

B. Legislative Background

Reduced tax rate for capital gains

Noncorporate capital gains were taxable at reduced rates from 1921 through 1987. The Revenue Act of 1921 ("1921 Act") provided for a maximum 12.5 percent tax on gain on property held for profit or investment for more than two years (excluding inventory or property held for personal use). Because of the relatively low tax rates on ordinary income during the 1920s and 1930s, this provision benefited only higher bracket taxpayers.

The system of capital gains taxation in effect prior to the Tax Reform Act of 1986 dated largely from the Revenue Act of 1942 ("1942 Act"). The 1942 Act provided for a 50-percent exclusion for noncorporate capital gains or losses on property held for more than six months. The 1942 Act also included alternative maximum rates on capital gains taxes for noncorporate and corporate taxpayers. The basic structure of the 1942 Act was retained under the Internal Revenue Code of 1954.

The Revenue Act of 1978 ("1978 Act") increased the exclusion for noncorporate long-term capital gains from 50 to 60 percent and repealed the alternative maximum rate. Together with concurrent changes in the noncorporate minimum tax, this had the effect of reducing the highest effective rate on noncorporate capital gains from approximately 49 percent[9] to 28 percent. The reduction in the maximum individual rate from 70 to 50 percent under the Economic Recovery Tax Act of 1981 reduced the maximum effective capital gains rate from 28 percent to 20 percent.

The Tax Reform Act of 1986 ("1986 Act") repealed the provisions granting reduced rates for capital gains, fully effective beginning in 1988. The 1986 Act provided that the maximum rate on capital gains (i.e., 28 percent) would not be increased in the event the top individual rate was increased by a subsequent public law (unless that law specifically increased the capital gains tax rate). The Revenue Reconciliation Act of 1990 raised the maximum individual rate to 31 percent, and the Revenue Reconciliation Act of 1993

[8] Such appreciation might give rise to Federal estate and gift tax. The value of stock or other assets held at death would be included in the decedent's gross estate and, if not passing to a surviving spouse or to charity, the decedent's taxable estate as well.

The extent to which such inclusion gives rise to Federal estate and gift tax depends on the value of the decedent's cumulative taxable transfers. The Federal estate and gift tax rates begin at 18 percent on the first $10,000 of cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over $3 million. A unified credit in effect generally exempts the first $600,000 in cumulative taxable transfers from estate and gift tax. The graduated rates and unified credit are phased out by a 5-percent surtax imposed on cumulative taxable transfers in excess of $10 million and not exceeding $21,040,000.

[9] The 49-percent rate resulted in certain cases where the taxpayer was subject to the individual "add-on" minimum tax and the maximum tax "earned income" limitation.

raised the top tax rate to 39.6 percent. Neither Act raised the maximum individual capital gains rate.

The Internal Revenue Code of 1954 as originally enacted provided for an alternative tax rate of 25 percent on corporate capital gains. The Tax Reform Act of 1969 raised this rate to 30 percent. The 1978 Act reduced the alternative rate to 28 percent. The 1986 Act repealed the alternative rate.

Holding period

Under the 1921 Act, the alternative maximum rate for capital gains applied to property held for more than two years. Since that time, Congress has, on several occasions, adjusted the holding period required for reduced capital gains taxation.

The Revenue Act of 1934 ("1934 Act") provided for exclusion of varying percentages of capital gains and losses depending upon the period for which an asset was held. Under that Act, 20 percent of capital gains was excludible if an asset was held for one to two years, 40 percent if an asset was held for two to five years, and 60 percent if the asset was held for between five and ten years. Where an asset had been held for more than 10 years, 70 percent of capital gains was excluded.

The Revenue Act of 1938 ("1938 Act") provided for two classes of long-term capital gains. For assets held for 18 months to two years, a 33-percent exclusion was allowed. Where assets were held for more than two years, a 50-percent exclusion was provided. No exclusion was allowed for assets held for 18 months or less. The 1938 Act also provided alternative ceiling rates applicable to the same holding periods as the capital gains exclusions.

In the Revenue Act of 1942 ("1942 Act"), Congress eliminated the intermediate holding period for capital gains purposes. The 1942 Act provided for two categories of capital assets: assets held for more than six months (long-term capital assets), for which a 50-percent exclusion was allowed; and assets held for six months or less (short-term capital assets), for which no exclusion was provided. The alternative tax rates on individual and corporate net capital gains (i.e., the excess of net long-term capital gains over short-term capital losses) were based upon the same six-month holding period.

A six-month holding period for long-term capital gains treatment remained in effect from 1942 through 1976. The Tax Reform Act of 1976 ("1976 Act") increased the holding period to nine months for 1977 and to one year for 1978 and all subsequent years. The Deficit Reduction Act of 1984 reduced the holding period to six months for property acquired after June 22, 1984, and before 1988. After 1988, the holding period is one year.

Treatment of gain and loss on depreciable assets and land used in trade or business

Depreciable property used in a trade or business was excluded from the definition of a capital asset by the 1938 Act, principally because of the limitation on deductibility of losses imposed by the 1934 Act. This step was motivated in part by the desire to remove possible tax deterrents to the replacement of antiquated or obsolete assets such as equipment, where depreciation would be fully deductible against ordinary income if the asset were retained, but loss would be subject to the capital loss limitations if the asset were sold.

The availability of capital gain treatment for gains from sales of depreciable assets stems from the implementation of excess profits taxes during World War II. Many depreciable assets, including manufacturing plants and transportation equipment, had appreciated substantially in value when they became subject to condemnation or requisition for military use. Congress determined that it was unfair to tax the entire appreciation at the high rates applicable to wartime profits. Accordingly, in the 1942 Act, gains from wartime involuntary conversions were taxed as capital gains. The provision was extended to voluntary dispositions of assets since it was not practical to distinguish condemnations and involuntary dispositions from sales forced upon taxpayers by the implicit threat of condemnation or wartime shortages and restrictions.

The 1938 Act did not exclude land used in a trade or business from the capital asset definition. Since basis would have to be allocated between land and other property for purposes of depreciation in any event, the differing treatment of land used in a trade or business and depreciable property used in a trade or business was not viewed as creating serious allocation difficulties.

However, in the 1942 Act, Congress excluded land used in a trade or business from the definition of a capital asset and extended to such property the same special capital gain/ordinary loss treatment afforded to depreciable trade or business property.

In 1962, Congress required that depreciation on section 1245 property (generally, personal property) be recaptured as ordinary income on the disposition of the property. In 1964, Congress required that a portion of the accelerated depreciation on section 1250 property (generally, real property) be recaptured as ordinary income. Subsequent amendments have required that the entire amount of accelerated depreciation on section 1250 property be recaptured as ordinary income. However, any depreciation taken to the extent allowable under the straight-line method is generally not recaptured as ordinary income, but rather creates capital gain.

Capital losses

Noncorporate taxpayers

In the early years of the Federal income tax, losses from investments not connected with a trade or business were not deductible even against gains from similar transactions. This rule was changed in 1916 to allow deductions for transactions entered into for profit (but only to the extent of gains from similar transactions). The rule was further adjusted by the Revenue Act of 1918.

The 1921 Act provided that net capital losses were deductible in full against capital gains or ordinary income. Because capital gains at this time were taxable at a maximum 12.5-percent rate, but capital losses could be used to offset income taxable at higher rates, this rule resulted in substantial revenue loss. Accordingly, the rule was amended by the 1924 Act to limit the tax benefit from capital losses to 12.5 percent of the amount of such losses. The 1924 Act also repealed the previously existing carryforward for excess capital losses.

Under the 1934 Act, the percentage exclusion for net capital gains was made dependent upon the length of time for which the property was held. In conjunction with this change, the 1932 Act allowed equivalent percentages of capital losses to be deducted against capital gains and, in the event of any excess, against $2,000 of ordinary income. The $2,000 limit on the amount of ordinary income against which capital losses could be deducted was motivated by the fact that some very wealthy investors had been able to eliminate all their income tax liability by deducting losses incurred in the stock market crash against ordinary income.

Under the 1942 Act, capital losses could offset up to $1,000 of ordinary income with a carryforward of unused losses. The 1976 Act increased this amount to $3,000. Between 1970 and 1986, the net long-term loss that could be carried forward was reduced by $2 for every dollar of loss that offset ordinary income.

In 1958, individuals were allowed to deduct up to $25,000 ($50,000 on a joint return) of loss from the disposition of stock in a small business corporation as an ordinary loss. These limitations were doubled in the 1978 Act.

Corporate taxpayers

The 1942 Act provided a five-year carryforward of unused corporate capital losses. In 1969, a three-year carryback was added.

C. Description of Proposals

1. The "Capital Gains Tax Reduction Act of 1997" (H.R. 14) (Mr. Dreier and others)

a. Maximum capital gains tax rate for individuals

H.R. 14 would provide individuals with a maximum capital gains rate of 14 percent (7.5 percent for capital gains otherwise taxed at the 15-percent rate). The maximum rate would apply for purposes of the regular tax and the alternative minimum tax. The 50-percent exclusion for gain from small business stock would be repealed.

The provision generally would apply to taxable years beginning after December 31, 1996.

b. 28-percent corporate alternative tax for capital gains

The bill would provide an alternative tax of 28 percent on the net capital gain of a corporation if that rate is less than the corporation's regular tax rate.

The provision generally would apply to sales and exchanges of capital assets after December 31, 1996.

c. Indexing of basis of certain assets for purposes of determining gain

In general

The bill generally would provide for an inflation adjustment to (i.e., indexing of) the adjusted basis of certain assets (called "indexed assets") for purposes of determining gain and loss upon a sale or other disposition of such assets held more than three years by a taxpayer other than a C corporation. Assets held by trusts, estates, S corporations, regulated investment companies ("RICs"), real estate investment trusts ("REITs"), and partnerships are eligible for indexing, to the extent gain or loss on such assets is taken into account by taxpayers other than C corporations.

Indexed assets

Assets eligible for the inflation adjustment generally would include common (but not preferred) stock of C corporations and tangible property that are capital assets or property used in a trade or business. To be eligible for indexing, an asset must be held by the taxpayer for more than three years.

Computation of inflation adjustment

The inflation adjustment under the provision would be computed by multiplying the taxpayer's adjusted basis in the indexed asset by an inflation adjustment percentage. The inflation adjustment percentage would be the percentage by which the gross domestic product deflator for the last calendar quarter ending before the disposition exceeds the gross domestic product deflator for the last calendar quarter ending before the asset was acquired by the taxpayer, or the quarter ending December 31, 1996, whichever is later. The inflation adjustment percentage would be rounded to the nearest one-tenth of a percent. No adjustment would be made if the inflation adjustment is one or less.

Special entities

RICs and REITs

In the case of a RIC or a REIT, the indexing adjustments generally would apply in computing the taxable income and the earnings and profits of the RIC or REIT. The indexing adjustments, however, would not be applicable in determining whether a corporation qualifies as a RIC or REIT.

In the case of shares held in a RIC or REIT, partial indexing generally would be provided by the provision based on the ratio of the value of indexed assets held by the entity to the value of all its assets. The ratio of indexed assets to total assets would be determined quarterly (for RICs, the quarterly ratio would be based on a three-month average). If the ratio of indexed assets to total assets exceeds 80 percent in any quarter, full indexing of the shares would be allowed for that quarter. If less than 20 percent of the assets are indexed assets in any quarter, no indexing would be allowed for that quarter for the shares. Partnership interests held by a RIC or REIT would be subject to a look-through test for purposes of determining whether, and to what degree, the shares in the RIC or REIT are indexed.

A return of capital distribution by a RIC or REIT generally would be treated by a shareholder as allocable to stock acquired by the shareholder in the order in which the stock was acquired.

Partnership and S corporations, etc.

Under the bill, stock in an S corporation or an interest in a partnership or common trust fund would not be an indexed asset.

Under the provision, the individual owner would receive the benefit of the indexing adjustment when the S corporation, partnership, or common trust fund disposes of indexed assets. Under the provision, any inflation adjustments at the entity level would flow through to the holders and result in a corresponding increase in the basis of the holder's interest in the entity. Where a partnership has a section 754 election in effect, a partner transferring his interest in the partnership would be entitled to any indexing adjustment that has accrued at the partnership level with respect to the partner and the transferee partner is entitled to the benefits of indexing for inflation occurring after the transfer.

The indexing adjustment would be disregarded in determining any loss on the sale of an interest in a partnership, S corporation or common trust fund.

Foreign corporations

Common stock of a foreign corporation generally would be an indexed asset if the stock is regularly traded on an established securities market. Indexed assets, however, would not include stock in a foreign investment company, a passive foreign investment company (including a qualified electing fund), a foreign personal holding company, or, in the hands of a shareholder who meets the requirements of section 1248(a)(2) (generally pertaining to 10-percent shareholders of controlled foreign corporations), any other foreign corporation. An American Depository Receipt (ADR) for common stock in a foreign corporation would be treated as common stock in the foreign corporation and, therefore, the basis in an ADR for common stock generally would be indexed.

Other rules

Improvements and contributions to capital

No indexing would be provided for improvements or contributions to capital if the aggregate amount of the improvements or contributions to capital during the taxable year with respect to the property or stock is less than $1,000. If the aggregate amount of such improvements or contributions to capital is $1,000 or more, each addition would be treated as a separate asset acquired at the close of the taxable year.

Suspension of holding period

No indexing adjustment would be allowed during any period during which there is a substantial diminution of the taxpayer's risk of loss from holding the indexed asset by reason of any transaction entered into by that the taxpayer, or a related party.

Short sales

In the case of a short sale of an indexed asset with a short sale period in excess of three years, the bill would require that the amount realized be indexed for inflation for the short sale period.

Related parties

The bill would not index the basis of property for sales or dispositions between related persons, except to the extent the adjusted basis of property in the hands of the transferee is a substituted basis (e.g., gifts).

Collapsible corporations

Under the bill, indexing would not reduce the amount of ordinary gain that would be recognized in cases where a corporation is treated as a collapsible corporation (under sec. 341) with respect to a distribution or sale of stock.

The provision would apply to dispositions of property after December 31, 1996.

2. The "Enterprise Capital Formation Act of 1997" (H.R. 420) (Mr. Matsui and Mr. English)

H.R. 420 would amend the rules relating to gain on certain small business stock by: (1) increasing the exclusion to 75 percent (this would create an effective maximum rate of tax on qualifying stock of 7 percent for individuals and 8.75 percent for corporations); (2) reducing the holding period from five to three years; (3) making corporations eligible for the exclusion, (4) repealing the minimum tax preference; (5) increasing the maximum size of the corporation from $50 million to $100 million, adjusted for inflation occurring after 1996; (6) repealing the $10-million per issuer limitation; (7) amending the working capital and the redemption rules; (8) allowing hotels, motels, and restaurants to be a qualified small business; and (9) allowing taxpayers to rollover gain from the sale or exchange of small business stock held more than three years if the proceeds are used to purchase other qualifying small business stock within 60 days of the original sale. The holding period of replacement stock would take the holding period of the stock it replaced.

The provisions generally would apply to stock issued after August 10, 1993. However, the provisions relating to the holding period, corporate shareholders, and the size of the business would apply only to stock issued after date of enactment, unless the taxpayer elects to recognize any gain that has accrued on the date of enactment. The rollover provision would apply to stock issued after date of enactment.

3. The "Return Capital To The American People Act" (H.R. 1033) (Ms. Dunn and others)

a. 50-percent capital gains deduction

The bill would allow all taxpayers (both individual and corporate) a deduction equal to 50 percent of net capital gain for the taxable year. The bill would repeal the present-law maximum 28-percent rate. Thus, the effective rate on the net capital gain of an individual in the highest (i.e., 39.6 percent) rate bracket would be 19.8 percent, and the effective rate for a corporation in the 35-percent bracket would be 17.5 percent.

The bill would reinstate the rule in effect prior to the 1986 Tax Reform Act that required two dollars of the long-term capital loss of an individual to offset one dollar of ordinary income. The $3,000 limitation on the deduction of capital losses against ordinary income would continue to apply.

Numerous conforming amendments would be made generally to reinstitute the capital gains deduction system in effect prior to the Tax Reform Act of 1986.

The provision generally would apply to dispositions after December 31, 1996.

b. Gain from sale of small business stock

The bill would make the same changes relating to gain on certain small business stock as would H.R. 420, except indexing of the $100 million business asset limitation would apply to inflation after 1997.

The provisions would be effective on the same dates as provided by H.R. 420, except the increase in the business asset limitation would be effective on August 10, 1993

c. Indexing of basis of certain assets for purposes of determining gain

The bill generally would provide for an inflation adjustment to (i.e., indexing of) the adjusted basis of certain assets (called "indexed assets") in a manner similar to H.R. 14 except that indexing would apply to all taxpayers, not only individual taxpayers.

The provision would apply to dispositions of property the holding period of which begins after December 31, 1996. The provision also would apply to a principal residence held by the taxpayer on January 1, 1997 (as if the holding period began on that date). An individual holding any indexed asset (other than a personal residence) on January 1, 1997, may elect to treat the indexed asset as having been sold and reacquired for its fair market value. If the election is made, any gain is recognized (and any loss is disallowed).

d. Capital loss deduction on the sale or exchange of a principal residence

The bill would provide that a loss from the sale or exchange of a principal residence would be treated as a deductible capital loss.

The provision would apply to sales and exchanges after December 31, 1996.

4. Exclusion of Capital Gains on Sale of Principal Residence (The President's Fiscal Year 1998 Budget Proposal)

A taxpayer generally would be able to exclude up to $250,000 ($500,000 if married filing a joint return) of capital gain realized on the sale or exchange of a principal residence. The exclusion would be allowed each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but generally no more frequently than once every two years. The proposal provides that gain would be recognized to the extent of any depreciation allowable with respect to the rental or business use of such principal residence for periods after December 31, 1996.

To be eligible for the exclusion, a taxpayer must have owned a residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange of the residence. A taxpayer who is forced to sell without meeting these requirements (e.g., because of a change of place of employment or medical reasons) would be able to exclude the fraction of the $250,000

($500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.

In the case of joint filers not sharing a principal residence, an exclusion of $250,000 would be available on a qualifying sale or exchange of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the proposal would allow the newly married taxpayer a maximum exclusion of $250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude $500,000 of gain on their joint return.

The proposal would be available for all sales or exchanges of a principal residence occurring on or after January 1, 1997, and would replace the present-law rollover and one-time exclusion provisions applicable to principal residences. In the case of sales or exchanges occurring between January 1, 1997 and the date of enactment, taxpayers could elect whether to apply the new exclusion or prior law. For a taxpayer who acquired his or her current principal residence in a rollover transaction within the five years prior to the date of enactment, the residency requirement of the proposal would be applied by taking into account the period of the taxpayer's residence in the previous principal residence.

5. "American Family Tax Relief Act" (S. 2) (Senator Roth and others)

a. 50-percent capital gains deduction for individuals

S. 2 would allow individuals a deduction equal to 50 percent of net capital gain for the taxable year in a manner similar to H.R. 1033, except collectibles would not be allowed the capital gains deduction; instead a maximum rate of 28 percent would apply to the gain of an individual from the sale or exchange of collectibles held for more than one year if the individual did not index the basis of the collectible.

The provision would generally apply to sales and exchanges of capital assets after December 31, 1996.

b. Indexing of basis of certain assets for purposes of determining gain

The bill generally would provide for an inflation adjustment to (i.e., indexing of) the adjusted basis of certain assets (called "indexed assets") in a manner similar to H.R. 14 except that indexing would apply only for purposes of determining gain (not loss).

The indexing provision would have the same effective date as does H.R. 1033.

c. Gain from sale of small business stock

Under the bill, the maximum rate of regular tax on the qualifying gain from the sale of small business stock by a taxpayer other than a corporation would remain at 14 percent. The minimum tax preference would be repealed.

The bill would increase the size of an eligible corporation from gross assets of $50 million to gross assets of $100 million. The bill also would repeal the limitation on the amount of gain an individual can exclude with respect to the stock of any corporation.

The bill would provide that certain working capital must be expended within five years (rather than two years) in order to be treated as used in the active conduct of a trade or business. No limit on the percent of the corporation's assets that are working capital would be imposed.

The bill would provide that if the corporation establishes a business purpose for a redemption of its stock, that redemption is disregarded in determining whether other newly issued stock could qualify as eligible stock.

The increase in the size of corporations whose stock is eligible for the exclusion would apply to stock issued after the date of the enactment of the bill. The remaining provisions would apply to stock issued after August 10, 1993 (the original effective date of the small business stock provision).

d. 28-percent corporate alternative tax for capital gains

The bill would provide an alternative tax of 28 percent on the net capital gain of a corporation if that rate is less than the corporation's regular tax rate.

The bill also would provide an alternative rate of 21 percent on the gain from the sale or exchange of qualified small business stock (other than stock of a subsidiary corporation) held more than five years.

The provision generally would apply to sales and exchanges of capital assets after December 31, 1996.

The small business stock provision would apply to stock issued after the date of enactment.

e. Capital loss deduction on the sale or exchange of a principal residence

The bill would provide that a loss from the sale or exchange of a principal residence would be treated as a deductible capital loss.

The provision would apply to sales and exchanges after December 31, 1996.

D. Analysis of Issues

1. Scope of Capital Gains Taxation

In 1994, among individual taxpayers who filed Form 1040, Schedule D,[10] 11 million taxpayers recognized $168 billion in long-term capital gains and 3.5 million taxpayers recognized $23.2 billion in short-term capital gains. In addition, 5.8 million taxpayers reported $8.5 billion of capital gain distributions, generally received from mutual funds. Taxpayers also reported $78.2 billion of long-term capital losses on 6.5 million returns and $47.5 billion in short-term losses on 3.6 million returns.[11]

While these data represent a substantial number of transactions and a substantial amount of economic activity, not all transactions

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[10] Capital gains may also be reported on Schedule B of Form 1040, Form 2119, Form 4684, Form 4797, Form 6252, Form 6781, and Form 8824. Therefore, the following figures understate the total amount of gains and losses recognized in 1994.

[11] The staff of the Joint Committee on Taxation derived these figures from tabulations of Statistics of Income ("SOI") data on 1994 individual income tax returns.

are taxable transactions. Many capital gains (and losses) are recognized annually by tax-exempt persons such as pension funds, private foundations, and charities. In addition, foreign persons generally are exempt from tax on capital gains recognized in the United States.

Because gain recognition by taxpayers is elective, many analysts believe that capital gains recognized by taxable persons represent a fraction of the gains accrued by taxable persons annually. Estimates of the percentage of gains recognized by taxable persons to the total accrued gains earned by taxable persons range from 15 to 50 percent.[12] If the gains recognized annually fall short of accrued gains, the stock of accrued, but unrecognized capital gains, is growing through time and recognized capital gains in any one year would represent a small percentage of the total stock of accrued, and hence potentially recognizable, gains.[13]

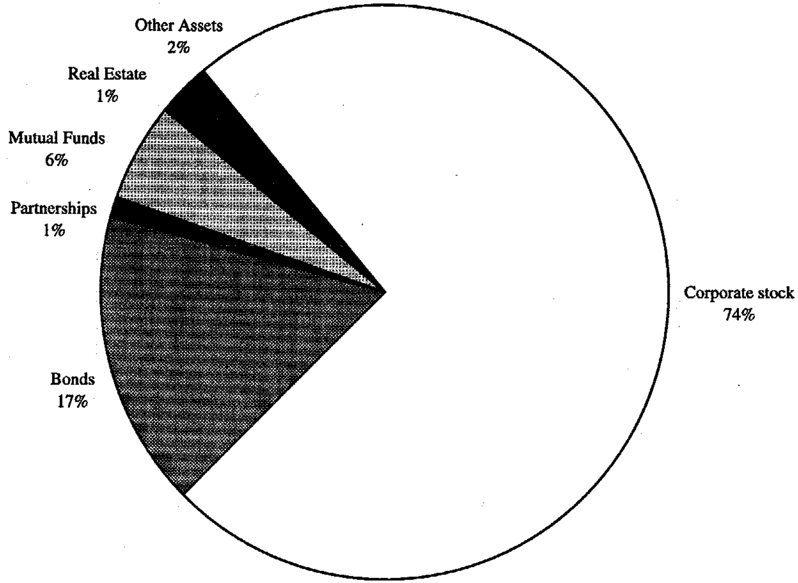
The majority of the dollar value of gains recognized represented gains from the sale of corporate stock or mutual funds, interests in partnerships, S corporations or certain fiduciaries, and the sale of real estate. Figures 1a and 1b, below, reports the distribution of long-term capital gains by number of transactions and by the dollar value of the gains recognized by a sample of individual taxpayers in 1994. These data report only recognitions reported on Schedule D and thus may not be fully representative of the distribution of all gain recognitions.[14] Nevertheless, Figures 1a and 1b should represent a substantial portion of 1994 recognitions.

[12] See Robert Gillingham and John S. Greenlees, "The Effect of Marginal Tax Rates on Capital Gains Revenue: Another Look at the Evidence," *National Tax Journal*, 45, June 1992, pp. 167-177. Such estimates vary widely from year to year. Gillingham and Greenlees estimate that 1989 taxable realizations were 16 percent of 1989 accruals, but that taxable realizations averaged 25 percent of accruals between 1987 and 1989. However, their estimate of accruals is based upon the Federal Reserve Board's "Flow of Funds Account" and may overstate the percentage as accrued taxable gains may be understated because the Flow of Funds Accounts do not adjust for depreciation claimed against the tax basis of taxable assets. Jane Gravelle, "Limits to Capital Gains Feedback Effects," CRS Report for Congress, 91-250, March 15, 1991, estimates average taxable realizations to be approximately 50 percent of potentially taxable annual average accrued gains. Jane Gravelle and Lawrence B. Lindsay, "Capital Gains," *Tax Notes*, 38, January 25, 1988, estimate that taxable recognized gains average one third of annual accrued gains.

[13] Gillingham and Greenlees, "The Effect of Marginal Tax Rates on Capital Gains Revenue." Gillingham and Greenlees estimated that 1989 realizations represented less than 2.5 percent of the stock of accrued since acquisition, but unrealized, capital gains held by taxpayers.

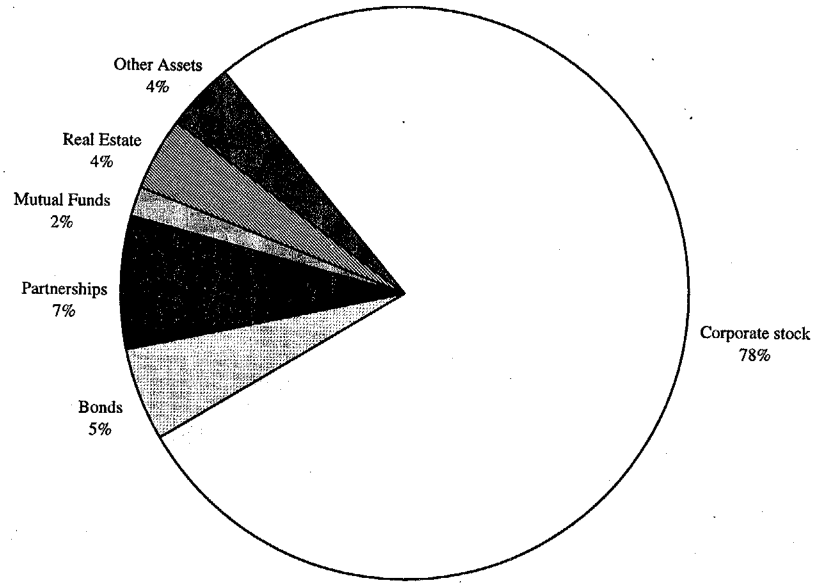
[14] The staff of the Joint Committee on Taxation drew these data from a sample of 1994 tax returns. The sample may not statistically reflect the recognition patterns of all taxpayers. See Appendix Table A.1 for underlying data. The categories in Figures 1a and 1b are defined as follows. "Corporate Stock" consists of sales of corporate stock, but not sales of mutual fund shares. However, "corporate stock" also includes certain indirect gains on stock recognized by a partnership and passed through to the individual partner. "Bonds" consists of sales of U.S. Government obligations, State and local government obligations, other bonds, notes, and debts, and sales of shares in tax-exempt municipal bond funds or trusts. "Partnerships" consists of sales of interests in partnerships, S corporations, or certain fiduciaries. "Mutual Funds" consists of sales of shares in mutual funds other than tax-exempt municipal bond funds. "Real Estate" consists of sales of residential rental property, personal residences, and land other than farm or ranch land. "Other" encompasses sales of options, commodities, futures contracts, livestock, timber, farm and ranch land, depreciable business personal property, depreciable business real property, involuntary conversions other than from casualties and thefts, interests in pass through entities not classified elsewhere, unidentified assets, and other assets.

Figure 1a.--Distribution of Transactions with Long-Term Gain Reported on Schedule D By Asset Type, 1994



NOTE: Sample from Schedule D may not be representative of all gain recognitions.

Figure 1b.--Distribution of Dollar Value of Long-Term Gains Reported on Schedule D By Asset Type, 1994



NOTE: Sample from Schedule D may not be representative of all gain recognitions.

The data in Figures 1a and 1b show the dominance of corporate stock in capital gain realizations in 1994. In addition, sales of interests in partnerships, S corporations, and certain fiduciaries accounted for 7.4 percent of the value of long-term gains realized and 1.0 percent of transactions. Long-term gains from the sale of real estate other than farmland comprised 2.4 percent of the total value of gains and 1.1 percent of the transactions. Long-term gains from the sale of bonds (U.S. government, State and local government, including tax-exempt bond funds, and other bonds, notes, and debts) comprised 5.3 percent of the total value of gains and 16.7 percent of transactions.

While sales of corporate stock are always an important component of annual capital gain realizations, the degree of importance varies from year to year. For example, 1989 return data show that 38.4 percent of 1989 long-term gain recognitions involved corporate stock (excluding capital gain distributions) and accounted for 22.6 percent of the dollar value of net gains; sales of interests in partnerships, S corporations, and fiduciaries accounted for 11.5 percent of transactions and 28.3 percent of the dollar value; and sales of real estate[15] accounted for 9.0 percent of transactions and 24.6 percent of the dollar value.[16]

The holding period of recognized gains varies from a matter of moments to decades. Figures 2a and 2b below report the percentage distribution of long-term gain recognitions by length of holding period for a sample of long-term gains recognized in 1994 and reported on Schedule D.[17] Figure 2a reports the distribution by number of transactions and Figure 2b reports the distribution by dollar value of gains recognized. In terms of number of transactions (Figure 2a), the median long-term gain was held between two and three years. When measured by the dollar value of long-term gains recognized (Figure 2b), the median long-term gain was recognized after being held by the taxpayer between five and six years.

Figures 3a and 3b report the percentage distribution of long-term loss recognitions by length of holding period.[18] As Figure 3a indicates, more than 50 percent of long-term losses are recognized after a holding period of less than two years. When measured by the dollar value of loss, the median occurs between years two and three (Figure 3b). These findings are consistent with advice given to taxpayers by financial planners to recognize losses, because they can offset gain recognitions and perhaps other income, and defer gain recognition. These data only represent the holding period of realized gains and losses. Also, they do not report the quantity or dollar magnitude of short-term (less than one year) gain and loss realizations. As such, these figures overstate the holding period of realized capital gains and losses. On the other hand, as reported above, the stock of accrued, but unrealized, gains may be substantial in

[15] Real estate includes taxable sales of personal residences, residential rental property, and land other than farmland.

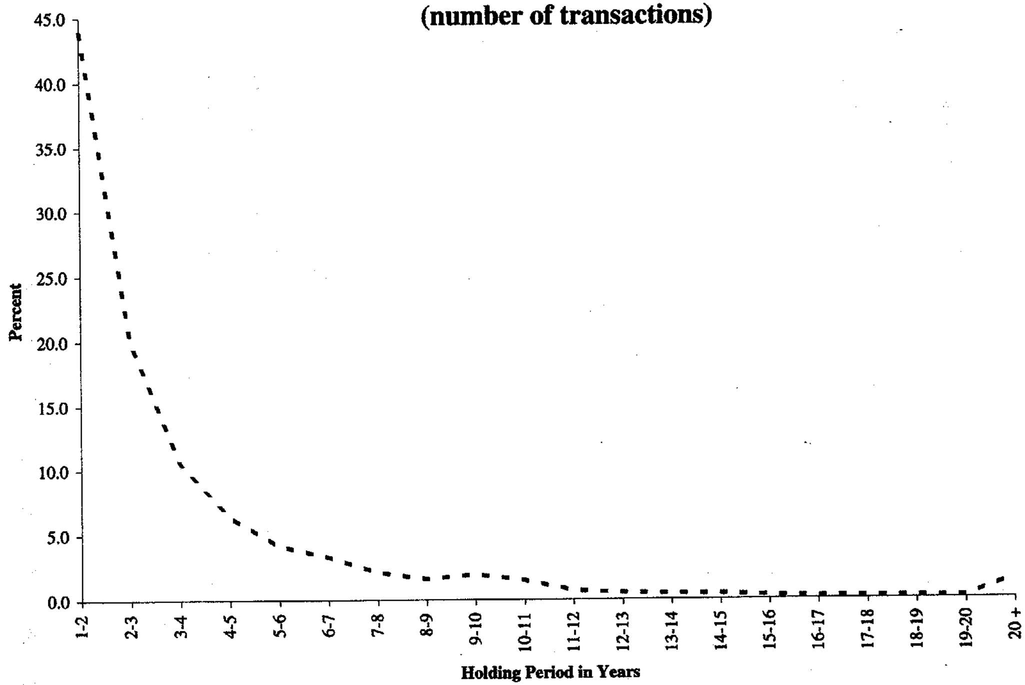
[16] 1989 data from tabulations of the 1989 Sale of Capital Assets file from the Statistics of Income Division of the Internal Revenue Service. This encompasses reporting of transactions beyond those reported on Schedule D.

[17] These figures draw on the same sample of individual taxpayer transactions reported on Schedule D in 1994 as were Figures 1a and 1b. Appendix Table A.2 contains the data underlying Figures 2a and 2b. As Figures 1a and 1b demonstrated, in 1994, these sales of corporate stock dominate these data.

[18] The data underlying Figures 3a and 3b is in Appendix Table A.3.

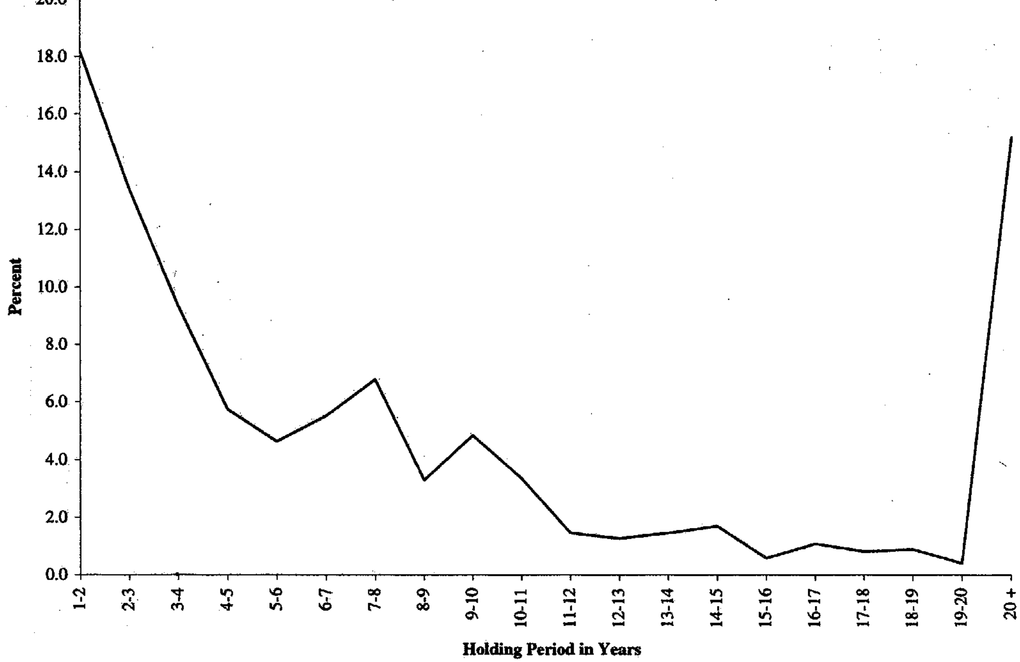
comparison to annual asset dispositions. This does not make it possible to assess the median holding period of all capital assets.

Figure 2a.--Percentage Distribution of Holding Period of Long-Term Gains, 1994 (number of transactions)



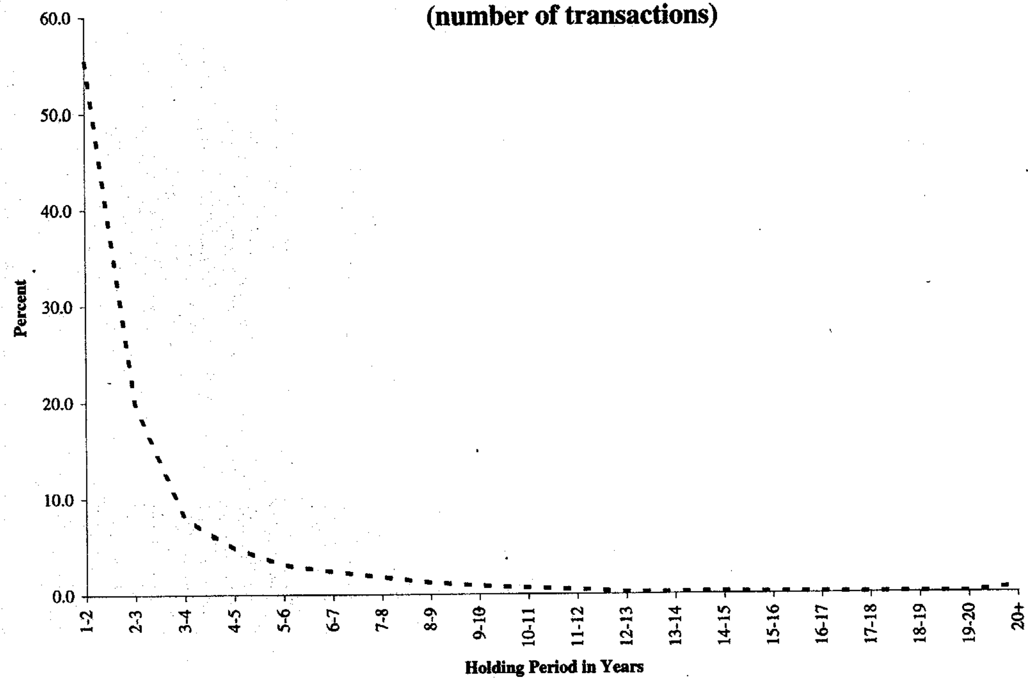
NOTE: Sample from Schedule D may not be representative of all gain recognitions.

Figure 2b.--Percentage Distribution of Holding Period of Long-Term Gains, 1994 (dollar value of transactions)



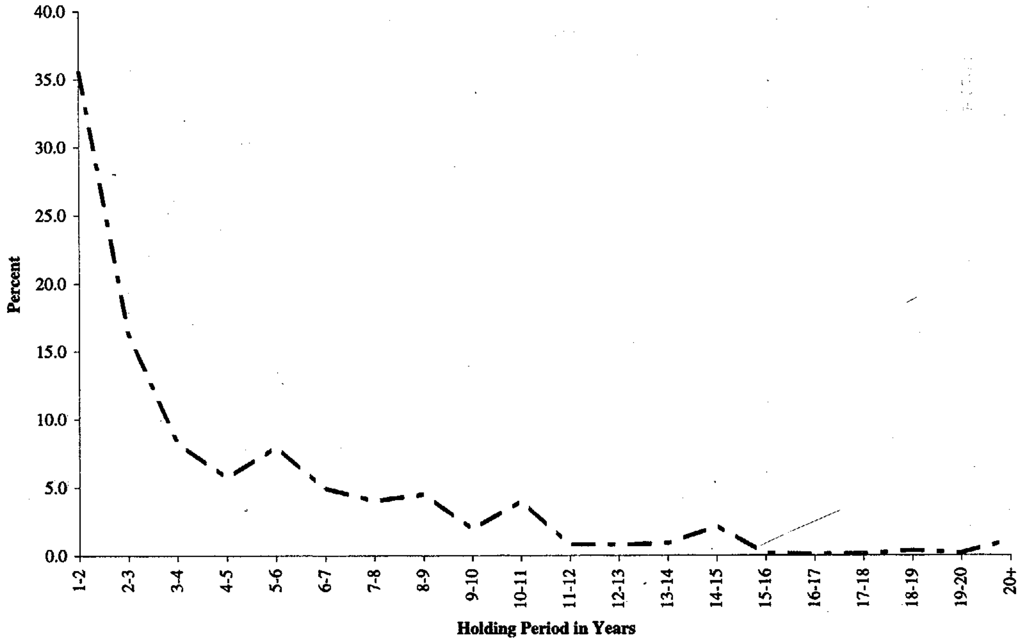
NOTE: Sample from Schedule D may not be representative of all gain recognitions.

Figure 3a.--Percentage Distribution of Holding Period of Long-Term Losses, 1994 (number of transactions)



NOTE: Sample from Schedule D may not be representative of all loss recognitions.

Figure 3b.--Percentage Distribution of Holding Period of Long-Term Losses, 1994 (dollar value of transactions)



NOTE: Sample from Schedule D may not be representative of all loss recognitions.

2. Issues Relating to a Reduced Tax on Capital Gains

Arguments for reduced tax on capital gains

Lock-in

Many argue that higher income tax rates discourage sales of assets. For individual taxpayers, this lock-in effect is exacerbated by the rules that allow a step up in basis at death and defer or exempt certain gains on sales of homes. The legislative history suggests that this lock-in effect was an important consideration in Congress' decision to lower capital gains taxes in 1978. As an example of the lock-in effect, suppose a taxpayer paid $500 for a stock that now is worth $1,000, and that the stock's value will grow by an additional 10 percent over the next year with no prospect of further gain thereafter. Assuming a 28-percent tax rate, if the taxpayer sells the stock one year or more from now, he or she will net $932 after payment of $168 tax on the gain of $600. If the taxpayer sold this stock today, he or she would have, after tax of $140 on the gain of $500, $860 available to reinvest. The taxpayer would not find it profitable to switch to an alternative investment unless that alternative investment would earn a total pre-tax return in excess of 11.6 percent.[19] Thus, the taxpayer is said to be "locked in" to the existing, lower-earning investment. Preferential tax rates on capital gains impose a smaller tax on redirecting monies from older investments to projects with better prospects, which contributes to a more efficient allocation of capital.

A preferential tax rate on capital gains would both lower the tax imposed when removing monies from old investments and increase the after-tax return to redirecting those monies to new investments. When the tax imposed on removing monies from old investments is reduced, taxpayers would not necessarily redirect their funds to new investments when their older investments are sold. Taxpayers might instead choose to consume the proceeds.[20] Some have suggested that the lock-in effect could be reduced without lowering taxes on old investments. For example, eliminating the step-up in basis upon death would reduce lock in. Lock in could be eliminated while still taxing gains upon their realization by vary-

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[19] Intuitively, the taxpayer is comparing retaining his or her funds in the current investment as opposed to switching those funds to an alternative investment. If the taxpayer switches investments, by recognizing gain and paying tax, the taxpayer has a smaller principal amount to invest in the alternative investment than if he or she were to retain the funds in the current investment. Because the taxpayer will have a smaller invested principal in the alternative investment, the alternative investment may have to earn substantially higher returns than would the current investment, for the taxpayer's wealth to be greater by making the switch.

[20] One study argues that second mortgages (or home equity loans or lines of credit) permit taxpayers to "realize" accrued capital gains on their personal residences without paying tax. The study presents data that indicate that taxpayers use their accrued gains to finance increased consumption more often than re-investment. Such behavior would reduce personal saving and investment. See Joyce M. Manchester and James M. Poterba, "Second Mortgages and Household Saving," *Regional Science and Urban Economics*, vol. 19, May 1989. Another study observes that because capital gains realizations are positively correlated to a taxpayer's "permanent," or long-run average, income and negatively correlated to "transitory" income (short run deviations about permanent income) many realization decisions might be motivated by a consumption motive. See Leonard E. Burman and William C. Randolph, "Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data," *American Economic Review*, 84, September 1994, pp.794-809.

ing the tax to the size and holding period of the gain.[21] However, such a proposal may be administratively complex. Alternatively, preferential tax rates only for gains on newly acquired assets would increase the after-tax return to new investments, thereby making reallocation of investment funds more attractive than currently is the case.

Proponents of a preferential tax rate on corporate capital gains observe that corporations have the same ability to defer realization and, consequently corporations can be subject to substantial lock-in effects. However, opponents have argued that the lock-in effect should not be as strong for capital gains accrued on assets held by corporations as on assets held by individual taxpayers because corporate assets do not receive the benefit of a step up in basis at death. Also, many corporate assets do not represent portfolio investments, but rather are held in furtherance of the corporation's business activity. Therefore, there is likely to be less discretion in the timing of realization of corporate assets.

Incentives for equity investments and risk taking

A second argument for preferential capital gains tax rates is that they encourage investors to buy corporate stock, and especially encourage investors to provide venture capital for new companies, thereby stimulating investment in productive business activities. This argument was important in the 1978 debate over capital gains taxes, and a large growth in the availability of venture capital occurred after 1978. In theory, when a tax system accords full offset for capital losses (see below for further discussion of losses), a reduction in tax rates applicable to capital gains and losses would reduce risk taking. This is because with full loss offset the government acts like a partner in the investment, bearing an equal share of the risk, both good and bad.[22] However, the present-law limitation on taxpayers' ability to offset capital losses against other income creates a bias against risk taking by implicitly reducing the value of any loss by deferring its inclusion in income. A reduction in the tax rate on realized gain, proponents argue, therefore should increase risk taking. Proponents argue that the preference provides an incentive for investment and capital formation, with particular importance for venture capital and high technology projects.

Others argue that the capital gains preference may be an inefficient mechanism to promote the desired capital formation. They argue that a preferential capital gains tax rate, broadly applied, is not targeted toward any particular type of equity investment. They observe that present-law section 1202 (that provides certain small businesses with a reduced tax on realized capital gains) and present-law section 1244 (that provides expanded loss offset for investments in certain small business stock) more specifically target risk-taking activities. Replacing those provisions with a broadly applicable capital gains preference may place such investments at a relative disadvantage as compared to present law. Furthermore, a

[21] For a description of a proposal to eliminate lock in completely while retaining taxation upon realization, see Alan J. Auerbach, "Retrospective Capital Gains Taxation," *American Economic Review*, 81, March 1991.

[22] Evsey D. Domar and Richard A. Musgrave, "Proportional Income Taxation and Risk Taking," *Quarterly Journal of Economics*, 58, May 1944.

broad capital gains preference affords capital gains treatment to non-equity investments such as gains on municipal bonds and certain other financial instruments.

Moreover, opponents of a capital gains preference point out that a tax preference could have only a small incentive effect on investment because a large source of venture capital and other equity investment is tax-exempt or partially tax-exempt entities (for example, pension funds and certain insurance companies and foreign investors). For example, since 1978, tax-exempt entities (pension funds and non-profit institutions) have constituted the fastest growing source of new venture capital funds.[23] On the other hand, proponents argue that preferential capital gains treatment for venture capitalists who are taxable is important. They argue that this is particularly acute for the entrepreneur who often contributes more in time and effort than in capital. They further observe that initial investors in new ventures are frequently friends and family of the entrepreneur, all of whom are taxable. The organized venture capitalists are more prevalent at later stages of financing.

Opponents of a capital gains preference argue that creating a preference for capital gains could encourage the growth of debt and the reduction of equity throughout the economy. When debt is used in a share repurchase program or leveraged buyout transaction the taxpayers who hold the original equity securities must realize any gain that they might have. A lower tax rate on gains could make holders of equity more likely to tender their shares in a leveraged buyout transaction or share repurchase program. On the other hand, by favoring returns to equity, a capital gains preference could encourage greater issuance of equity and less reliance on debt when raising new capital.

Savings incentive

The United States has a relatively low rate of household saving, currently less than 5 percent of disposable income. This rate is low both in comparison to other industrialized countries and in comparison to prior United States experience. At the aggregate level, a low saving rate is a concern because saving provides the wherewithal for investment in productivity-enhancing equipment and technology. At the household level, a low saving rate may imply households are accumulating insufficient assets for retirement, emergencies, or other uses.[24] By reducing the tax on realized capital gains, the after-tax return to household saving is increased.

Theoretically, the effect on saving of a reduction of taxes on capital income is ambiguous. There are two effects. First, the increased return to saving should encourage people to save more. Second, the increased return people receive on assets they have already accumulated and on saving they had already planned increases their income. This increased income may encourage them to increase their consumption and may reduce their saving. Empirical economic evidence also is ambiguous on whether, and in what

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[23] James M. Poterba "Venture Capital and Capital Gains Taxation," in Lawrence H. Summers (ed.), *Tax Policy and the Economy* (Cambridge: MIT Press), 1989.

[24] For a discussion of the importance of saving in the economy and a review of U.S. savings rates over the past three decades and in comparison to that of other countries, see Part III.D.3.

magnitude, household saving responds to changes in the after-tax rate of return.[25]

In addition, reduction only in the tax applicable to capital gains may prove to be an inefficient saving incentive. By favoring certain types of assets (those that generate returns in the form of accrued gains) over other types of assets (those that generate returns in the form of interest, dividends, or royalties), taxpayers may reallocate their holdings of assets to obtain higher after-tax returns without saving new funds. Such portfolio reallocations also represent reduced efficiency of capital markets as choices have been distorted.

Competitiveness

Related to the argument that preferential capital gains tax rates encourage saving and investment is the argument that a lower capital gains tax rate will improve the international competitive position of the United States. Proponents of a reduction in capital gain tax rates observe that many of our major trading partners have lower marginal tax rates on the realization of capital gains than does the United States. For example, the highest tax rate on capital gains in Canada is less than 25 percent. Japan imposes a tax at the taxpayer's discretion of either one percent of the gross proceeds or 20 percent of the gain, a rate below the maximum United States rate. In Germany, generally all long-term gains are exempt from income tax.

Others point out that the issue of the effect of capital gains taxes on international competitiveness is really one of the cost of capital of domestic firms compared to that of their competitors. Corporate income taxes, individual income taxes on interest and dividends, estate taxes, net wealth taxes,[26] as well as taxes on capital gains, all may affect the cost of capital. Proponents of a capital gains tax reduction contend that any reduction in a tax on capital should contribute to a reduction in the cost of capital. Opponents of a capital gains preference argue that the fact that marginal tax rates on capital gains are higher in the United States than in other countries does not imply automatically that American firms are at a competitive disadvantage. Tax rates on corporate income, interest, and dividends are often lower in the United States than in other countries. Moreover, because of the ability to defer gains, the opportunity to receive a step-up in basis at death, and the substantial holding of corporate equity by tax-exempt institutions, the effective tax rate on gains, which helps determine the cost of capital, may be substantially below the statutory rate. For example, one study calculated that prior to 1987 the effective marginal tax rate on capital gains, including State taxes, was less than 6 percent.[27] On the other hand, while other industrialized countries have lowered their tax rates since 1987, the United States has increased individual and corporate income tax rates. In addition, most other industri-

[25] For a brief review of the economic literature on taxpayer response to savings incentives, see Joint Committee on Taxation, *Tax Policy and the Macroeconomy: Stabilization, Growth, and Income Distribution* (JCS-18-91), December 12, 1991, pp. 48-49.

[26] While the United States does not impose an annual Federal tax on an individual's net wealth, several of our trading partners do (for example, Germany, the Netherlands, Spain, and Switzerland). See OECD, *Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals*, Paris, 1988.

[27] Don Fullerton, "The Indexation of Interest, Depreciation, and Capital Gains and Tax Reform in the United States," *Journal of Public Economics*, 32, February 1987, pp. 25-51.

alized countries have partially integrated corporate income tax systems which reduce the overall tax burden on investment.

Bunching

Because capital gain is generally not taxed until a disposition of an asset, taxpayers can face large jumps in taxable income when a gain is realized. With graduated tax rates, such bunching could lead to a higher tax burden than if the gain were taxed as it accrued. If the benefit of deferral is not enough to compensate for the extra tax in some of those cases, then the additional benefit of a preferential tax rate helps to achieve parity.

On the other hand, the maximum tax rate of 28 percent applicable to capital gains under present law[28] diminishes the amount of bunching and so, presumably, reduces the need for a further reduction in the tax rate as a remedy for it. Some analysts have stated that the most significant bunching problems under present law would now befall those taxpayers in the 15-percent marginal tax bracket whose gains could push them into the 28-percent bracket.

Inflation

While issues relating to indexing the basis of capital assets are discussed in more detail below, another argument for preferential tax treatment of capital gain is that part of the gain represents the effects of inflation and does not constitute real income. This argument was also an important factor in the 1978 capital gains rate reduction. Proponents observe that a preferential capital gains tax rate may provide to taxpayers some rough compensation for inflation.

Others note that a preferential tax rate is a very crude adjustment for inflation. For example, since 1980 the price level approximately has doubled. Thus, an asset purchased in 1980 for $1,000 and sold today for $2,000 would have a purely inflationary gain. Even with a preferential rate, this gain would be taxed. On the other hand, for an individual who purchased an asset in 1990 for $1,000 and sold it today for $2,000, a reduction in the tax rate from 28 percent to 19.8 percent would slightly more than offset the effects of inflation over the past seven years.[29] A preferential rate also does not account for the impact of inflation on debt-financed assets, where inflation reduces the cost of repaying the debt.

Some proposals would provide for both the indexing of basis and an exclusion from income or a preferential rate of tax for income from gain. If the taxation of inflationary gain is viewed as the primary defect of present-law taxation of income from capital gains, such proposals would provide tax reduction in excess of that required to eliminate the taxation of inflationary gain.

Double taxation of corporate earnings

Preferential capital gains treatment on a disposition of corporate stock might be viewed as ameliorating the double taxation of cor-

[28] Under present law the effective marginal tax rate on income from capital gains can exceed the statutory maximum of 28 percent. For example, a taxpayer subject to the limitation on itemized deductions would find the marginal tax owed on an additional $100 of capital gain to be approximately $29. Certain "phase out" ranges in the Code also may increase effective tax rates.

[29] Cumulative inflation since 1990 has totaled slightly over 21 percent.

porate earnings. The first step of double taxation occurs at the corporate level; the second step occurs at the shareholder level as dividends are paid or as shares that have increased in value (presumably by retained earnings) are sold. However, preferential capital gains treatment is a very inexact means of reducing any double taxation. Among other things, the capital gains holding period requirement is unrelated to earnings. Also, any relief that a capital gains preference provides from the burden of double taxation applies only to retained corporate earnings. Distributed earnings still would be generally subject to double taxation.[30]

The issue of double taxation ultimately is about the total effective tax rate on investment income. If the two "layers" of tax on income from investment in corporate form impose a small aggregate burden, one may not be concerned with the issue of double taxation. On the other hand, if the two layers of the tax imposed on income from investment in corporate form have a greater aggregate burden than the one layer of tax imposed, for example, on income from investment via a partnership, then double taxation may create a capital market inefficiency by creating a bias against investment in corporate form. A reduction in the rate of tax applicable to capital gains may reduce the magnitude of the bias against investment in corporate form by reducing the aggregate tax burdens on income from investment by either a corporation or a partnership.

Arguments against a reduced tax on capital gains

Measurement of income

Opponents of a reduced tax on capital gains argue that appreciating assets already enjoy a tax benefit from the deferral of tax on accrued appreciation until the asset is sold, which benefit reduces in whole or in part any bunching or inflationary effects.[31] As a result, the effective rate of taxation on realized capital gains is less than the rate of taxation applicable to assets that pay current income. The following example illustrates the benefit of deferral. Assume a taxpayer in the 28-percent tax bracket has $1,000 to invest and may choose between two investment alternatives, each of which generates a return of 10 percent annually. Assume the one investment is a certificate of deposit that pays the 10-percent return out annually as interest on which the taxpayer must pay tax. After paying tax, the taxpayer reinvests the principal and net proceeds in a new certificate of deposit. The other investment, stock in a company that pays no dividends, accrues the 10-percent return untaxed until a capital gain is realized. After eight years the after-tax value of the taxpayer's certificate of deposit would be $1,744.[32] After selling the stock and paying tax on the realized gain, the tax-

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[30] As noted above, most other industrialized countries that have a corporate income tax have "partially integrated" their corporate and individual income taxes by providing some tax relief for corporate dividends. However, such dividend relief does reduce the possibility of double taxation on retained earnings.

[31] Roger Brinner, "Inflation, Deferral and the Neutral Taxation of Capital Gains," *National Tax Journal*, vol. 46, December 1973.

[32] This is calculated as $1{,}000(1 + r(1 - t))^n$, where r is the interest rate (10 percent in this example), t is the marginal tax rate (28 percent in this example), and n is the number of years the asset is held (eight in this example).

payer would have $1,823.[33] In this particular example, the effective rate of taxation on the realized capital gain is 22 percent, rather than the statutory tax rate of 28 percent.[34]

In addition, if capital assets are debt-financed, inflation will reduce the real cost of borrowing to the extent interest is deductible and interest rates on that debt do not rise to compensate for the reduced value of principal repayments. Thus, debt financing may further tend to offset any adverse impact of inflation. Some opponents of the preference have contended that a direct basis adjustment by indexing for inflation would be more accurate and would reduce uncertainty regarding the eventual effective rate of tax on investments that might impair capital formation.[35]

Proponents of a preference for capital gains contend that the benefit of deferral is insufficient to make up for more than very modest inflation. Moreover, they note that not taxing accrued appreciation is an inherent aspect of a realization-based tax system.

Neutrality

To the extent that preferential rates may encourage investments in stock, opponents have argued that the preference tilts investment decisions toward assets that offer a return in the form of asset appreciation rather than current income such as dividends or interest. On the other hand, it is argued that asset neutrality is not an appropriate goal because risky investments that produce a high proportion of their income in the form of capital gains may provide a social benefit not adequately recognized by investors in the marketplace.

Reduction of "conversion" opportunities

Opponents of the preferential capital gains rate contend that it also encourages taxpayers to enter transactions designed to convert ordinary income to capital gains. Conversion can also occur through debt-financing the cost of assets eligible for capital gains rates. For example, if a taxpayer borrows $100 at 10-percent annual interest to acquire a capital asset that is sold for $110 a year later, and repays the borrowing with sales proceeds, the taxpayer has an interest deduction of $10 that can reduce ordinary income[36] and a capital gain of $10 subject to preferential rates. The taxpayer thus has a net after-tax positive cash flow even though on a pre-tax basis the transaction was not profitable.

On the other hand, it is argued that such "conversion" opportunities are simply an additional tax incentive for types of investments the capital gains preference is intended to encourage. In addition, the passive loss limitations of present law and "anti-conversion pro-

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[33] This is calculated as the $1,000 principal plus the net, after-tax gain of $(1{,}000(1 + r)^n - 1{,}000)(1 - t)$, where r is the interest rate (10 percent), t is the marginal tax rate (28 percent), and n is the number of years the asset is held (eight).

[34] The effective rate of taxation on a realized gain is calculated by asking what rate of tax on an asset that paid current income would yield an equivalent amount of net proceeds to the taxpayer if that asset were held until the taxpayer realized the capital gain.

[35] More detailed discussion of issues relating to indexation of capital gains is below (I.D.3. "Issues Relating to Indexing").

[36] Even if an interest deduction is subject to present-law investment interest limitations, it can be offset against investment income that is ordinary income assuming that the taxpayer has sufficient investment income.

visions" such as present-law section 1258 limit taxpayers' benefit or ability to "convert" ordinary income to capital gains.

Simplification and consistent treatment of taxpayers

Opponents of a preferential capital gains rate point out that the application of different tax rates to different sources of income inevitably creates disputes over which assets are entitled to the preferential rate and encourages taxpayers to mischaracterize their income as derived from the preferred source. Litigation involving holding period, sale or exchange treatment, asset allocation, and many other issues has been extensive in the past. A significant body of law, based both in the tax code and in judicial rules, has developed in response to conflicting taxpayer and Internal Revenue Service positions in particular cases. Its principles are complicated in concept and application, typically requiring careful scrutiny of the facts in each case and leaving opportunities for some taxpayers to take aggressive tax return positions. It has been argued that the results derived in particular cases lack even rough consistency, notwithstanding the substantial resources consumed in this process by taxpayers and the Internal Revenue Service.

On the other hand, it is argued that so long as a limitation on deductions of capital loss is retained, areas of uncertainty and dispute will continue to exist (for example, whether property was held primarily for sale to customers in the ordinary course of business). Because (as discussed further below) limitations on the deductibility of capital or investment losses may be desirable to limit the selective realization of losses without realization of gains, the potential for simplification and consistency may be limited.

3. Issues Relating to Indexing

In general

Proponents of indexing contend that indexing would accomplish the goals of reduced capital gains taxation while producing a more accurate measurement of economic income with greater neutrality. Opponents contend that indexing is complex and that it would not be necessary if efforts to control inflation are successful.

Inflation and effective real tax rates

Under present law, even modest annual inflation can significantly increase the effective real tax rate on income from realized capital gains. For example, assume an investor purchases stock for $100 and the stock appreciates in value at 10 percent per year. After five years the stock will be worth $161. If sold, and the investor is in the 28-percent tax bracket, the investor will incur a tax liability of $17. If over that five-year period inflation had averaged 3 percent per year, the investor would have needed to realize $116 from the sale of the asset to maintain his or her real purchasing power. Consequently, the investor's real gain is $45. A $17 tax on a $45 real gain implies an effective tax rate of 37.8 percent on real gains as compared to the statutory rate of 28 percent.

Table 1 reports transactions by a sample of individuals who realized nominal long-term capital gains on corporate stock in 1994.[37] For holding periods between one year and 19 years, the staff of the Joint Committee on Taxation has calculated a real (inflation-adjusted) capital gain.[38] The third column reports the aggregate dollar value of nominal gains by length of holding period. It is nominal gain on which tax is assessed under present law. The fourth column calculates the aggregate real (inflation-adjusted) dollar value of those nominal gains. The fifth column calculates the inflationary component of the nominal gain (nominal gain less real gain) as a percentage of the nominal gain. Hence, of assets acquired in 1992 and sold at a nominal gain in 1994, 10.2 percent of the gain was the inflation component on average. This implies the effective tax rate on real capital gains was increased, on average, by 11 percent by inflation. A similar study of taxable sales of corporate stock in 1973 calculated that of the $1,138 million in tax paid on nominal gains, only $661 million represented taxes attributable to the real component of that year's nominal gains.[39]

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[37] The data in Table 1 are drawn from the same sample of individual taxpayer transactions reported on Schedule D in 1994 as were Figures 1a and 1b except the sample is restricted to sales of corporate stock. The transactions are limited to those with net gain on corporate stock and holding period between one and 19 years.

[38] The staff of the Joint Committee on Taxation calculated the inflation component by taking the taxpayer's reported basis and increasing it by the cumulative inflation, as measured by the change in the Consumer Price Index (CPI), that occurred between the taxpayer's year of acquisition and 1994 (the year of sale). This assumes, for example, that all assets acquired in 1990 and disposed of in 1994 were held for four years. In reality the holding period of some assets acquired in 1990 and disposed of in 1994 will include some assets held for three years and one month and some held for four years and eleven months.

The real component was calculated as the difference between the nominal gain and the inflationary component. For the purposes of this calculation nominal gains were permitted to become real losses. This particular calculation is not intended to correspond to the manner in which any legislative proposal would index for the purpose of calculating gain.

[39] Martin Feldstein and Joel Slemrod, "Inflation and the Excess Taxation of Capital Gains on Corporate Stock," *National Tax Journal*, 31, June 1978, pp. 107–118.

Table 1.—Inflationary Component of Nominal Long-Term Gains Realized on Corporate Stock, 1994

Holding period in years—	Number of transactions	Dollar value of nominal gains ($ millions)	Dollar value of real gains ($ millions)	Inflation component as a percentage of nominal gain
1	55,657	402.9	362.1	10.1
2	23,188	294.1	264.0	10.2
3	10,403	197.5	172.0	12.9
4	5,492	119.3	96.0	19.5
5	3,284	90.9	72.6	20.2
6	2,449	104.9	88.7	15.4
7	1,576	129.2	111.9	13.4
8	1,054	51.0	36.0	29.4
9	829	90.0	70.1	22.1
10	730	57.3	48.2	15.8
11	483	22.1	19.4	12.4
12	311	18.9	14.0	26.0
13	278	16.0	13.8	14.0
14	291	36.7	33.0	10.1
15	185	10.0	8.0	19.8
16	137	23.6	−1.7	107.3
17	134	15.9	12.3	22.3
18	142	26.0	22.6	13.0
19	119	6.9	5.2	24.9

Note.—Sample from Schedule D may not be representative of all gain recognitions.

Source: Joint Committee on Taxation Staff calculations from Internal Revenue Service SOI data.

While, as discussed in Part II.D.2., above, the benefit of deferral can reduce the effective tax rate, proponents of indexing observe that because inflation is not predictable, non-indexed taxation implies an uncertain effective rate of taxation. This added uncertainty may discourage saving generally and, in particular, saving in assets that produce their returns in the form of accruing capital gains.

Non-indexed taxation of gain and saving and investment

In most respects, indexing the basis of capital assets for the purpose of determining gain may be thought of as providing an exclusion for gain that varies with the holding period of the asset. As such, the arguments discussed in Part II.D.2., above, regarding the lock-in effect, household saving, the cost of capital, and risk taking generally would apply to the indexation of basis for the purpose of determining gain.

It is possible that indexing might not relieve "lock-in" problems, because a taxpayer whose after-tax economic gain is protected against future inflation may decide to continue to hold an asset to obtain the benefits of tax deferral, or the benefits of tax exemption if the asset is held until death. Others contend that indexing alleviates "lock-in" by removing the burden of taxing nominal gains arising from inflation. Some critics question the value of indexing as a policy to promote risk taking. They observe that much of the basis of entrepreneurial effort, so-called "sweat equity," has a nominal basis of zero, and that indexing a zero basis provides no benefit.

To the extent the indexed basis is not used to compute a loss, it would create a notch at an index gain-value of zero. Such a notch produces inefficiencies in the taxation of real gains in much the same manner as present-law restrictions on using capital losses to offset other income. Such a notch is arguably inequitable as taxpayers with different nominal gains would be treated as having no real gain despite experiencing different losses in consumer purchasing power. On the other hand, to permit indexation for the determination of loss may create opportunities to create paper losses and expand the possibilities for tax arbitrage.

Issues related to partial indexing

Indexing income, but not expense

Indexation of income without indexation of cost may increase the possibility for tax arbitrage.[40] To the extent that the basis of certain assets is indexed but debt financing of those assets is not, the adjustment for inflation may be overstated. An overadjustment in favor of the taxpayer who finances assets can occur even if it is assumed that interest rates correctly anticipate inflation and rise in the marketplace to reflect the effect of inflation on borrower and lender. For example, suppose a taxpayer acquires an asset for $100 (fully debt-financed) and sells it one year later for $115. Inflation over the year is 5 percent. The lender and the taxpayer are each in a 28-percent tax bracket. The lender, seeking a 10-percent pretax rate of interest and anticipating 5-percent inflation, charges 15-percent interest for the year. On a pre-tax basis, the taxpayer receives $115 in return of basis and gain on the sale, but pays the lender $115 in interest and principal, producing no net cash flow.

If there is no indexing and no capital gains preference, the after-tax result is the same as the pre-tax economic result—i.e., the taxpayer receives $15 of income taxable at 28 percent and pays $15 of offsetting, deductible interest, producing no after-tax net cash flow. If both the basis of the asset and the interest on the financing are indexed, the taxpayer has $10 of gain and $10 of offsetting deductible interest, again producing no after-tax net cash flow.[41] However, if the basis of the asset is indexed for inflation but the financing is not indexed, then the taxpayer has $10 of gain (taxed at 28 percent) but a $15 deduction, producing an after-tax positive net cash flow of $1.40, assuming the deduction can be used in full to offset other income in the 28-percent bracket.[42] Thus, because

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[40] Some proposals would index only for increases in the price level. If the price level were to decline, as in the 1930s, taxpayers could be in the situation of reporting losses on what in fact could be real gains.

[41] Full indexing and no indexing generally will only achieve the same results where the asset is full debt-financed (i.e., the basis of the asset and the liability are the same).

[42] Indexing the basis of assets without indexing debt financing of such assets also overcompensates the borrower if interest rates do not rise enough to compensate for inflation on an after-tax basis. Thus, if the stated interest payment in the example is only $10 (rather than

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equity assets are indexed while debt is not, taxpayers will have an incentive to engage in transactions to take advantage of this tax arbitrage. This may increase the need for anti-arbitrage rules, which would increase the administrative cost and complexity of the tax system.

Defining indexed assets

If some but not all assets are indexed, additional consideration would have to be given to provisions designed to accomplish the desired results in certain special situations. For example, if stock but not debt is indexed (or if debt is indexed in a different manner than stock-for example, by interest adjustments rather than basis adjustments), the question arises whether some types of assets, such as preferred stock or convertible debt, should be classified as stock or as debt for this purpose.

If some assets are not indexed or are only indexed at the option of the holder, it would be necessary to provide for the appropriate treatment of various types of flow-through entities that may hold indexed assets but whose stock or interests may or may not be indexed. Conversely, if an interest in an entity is eligible for indexing but the entity may hold substantial non-indexed assets, consideration could be given to provisions designed to prevent taxpayers from indirectly obtaining indexing for nonqualified assets.

The question also arises whether indexing of an otherwise capital asset is appropriate in situations such as the disposition of stock in a controlled foreign corporation or foreign investment company, where present law requires ordinary income treatment to account for prior income deferral. In the case of depreciable assets, rules are necessary to prevent the churning of assets in order for the buyer to obtain a higher basis for depreciation than the seller's basis, where the seller's gain is not taxed as a result of indexing.

Complexity

Indexing would involve a significant amount of recordkeeping. Records of the cost of property and improvements generally are maintained under present law. However, records of the dates the cost are incurred are not relevant to the determination of tax liability once the asset has been held for one year.

Indexing would substantially increase the number of calculations necessary to calculate taxable gain for many common transactions. For example, consider an individual who sells stock in a regular corporation or in a mutual fund that was purchased 10 years before the sale and who reinvested the quarterly dividends in additional stock during the entire period. Under present law, the individual can add the original cost and the dollar amounts of each of the 40 reinvested dividend payments in order to obtain the stock's basis, which is subtracted from the sales proceeds in order to determine taxable gain. Assuming qualified assets must be held for three years before the benefits of indexing can be claimed, each of the

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$15), interest is not indexed, and there is no capital gains preference, the taxpayer will have both a pre-tax and after-tax positive net cash flow of $5.

Of course, under present law receipts of nominal interest payments represents income to the lender. In real, inflation-adjusted, terms the lender's income is overstated. This increases the effective tax rate on real interest income earned by lenders.

first 29 of the 41 components of basis (the original purchase plus the 40 dividend payments) would be multiplied separately by indexing factors based on the period elapsed between the calendar quarter the stock was purchased and it was sold, in order to determine the indexed basis of the stock for purposes of determining long-term indexed gain. The nominal basis of each of the next twelve purchases would be added together, as under present law, to determine the basis of non-indexed long-term gain. As under present law, the nominal basis of each of the last four purchases would be added together to determine the basis of non-indexed short-term gain.[43] Further, if the corporation or mutual fund had ever paid a return of capital distribution, adjustments would be needed to the basis of each separate block of stock. Similarly, if capital improvements were made to qualified property, records of the dates of improvements would have to be maintained in order to compute the basis of the property. On the other hand, most of this record-keeping and computation is required by present law. The additional factor added by indexation is the multiplication of each element by a different index number and the need to maintain more careful records regarding date of acquisition.

The basis adjustments to indexed assets held by passthrough entities such as partnerships, S corporations, common trust funds, regulated investment companies ("RICs") and real estate investment companies ("REITs") need to be reflected in the investor's basis in those entities. For example, the basis of a partnership or S corporation stock in the hands of a partner or shareholder is affected by numerous transactions, including distributions, that could complicate accurate indexing of those interests. One approach would be to pass through the adjustments of the partnership to the partners. Although this is a relatively simple passthrough system, where there is a change in the interests in the partnership before the partnership disposes of an indexed asset, the former partners will not receive the proper indexing adjustment and the newer partners will receive too large an adjustment.[44] Where the partners are in different tax brackets, this may lead to arrangements or transactions to reduce overall taxes. Of course, similar problems exist in present law. Capital gain can be allocated to partners who did not hold their partnership interests during the period in which the gain accrued on the partnership's assets.

In the case of RICs and REITs, some proposals would provide for indexing of "outside" basis by multiplying the otherwise applicable basis adjustment by a fraction based on the percentage of the entities' total assets that are indexed assets. This may lead to additional complication in computing gain.

Property may be acquired or disposed of pursuant to options, forward contracts, regulated future contracts, installment sales and contracts requiring contingent payments. A system of full indexing would need to consider the treatment of each of these instruments. Under a partial indexing system that does not take into account

[43] Similarly, if a one-year holding period were required, the first 37 of the 41 components would be multiplied separately by indexing factors and each of the last four purchases would be added together with no adjustment.

[44] The negotiated price for the transferred partnership interest might be adjusted to account for this adjustment.

debt, the timing of the amounts paid or received under these instruments are ignored on the grounds that there are two parties to the transaction, and if both parties to the transaction are denied indexing, the amount of indexing adjustments in the entire system is maintained. However, where parties are in different tax brackets, the tax system may not be made whole and tax planning is possible.[45] In the case of short sales of indexed assets, it may be appropriate to index the amount realized by the caller in order to maintain a symmetry between buyer and seller. A three-year requirement for indexation may obviate the practical need for such a rule.

In 1982, in response to high levels of inflation, the United Kingdom adopted a partial indexing system for inflation after 1982. The administrative burden in the United Kingdom is eased by providing all taxpayers with a 100-percent exclusion for the first 5,800 pounds sterling (approximately $9,000) of gains realized. Consequently, capital gains taxation applies to less than 1 percent of individual taxpayers in the United Kingdom. This means many taxpayers never have to make the computations required by indexing. While it may be the case that the less than 1 percent of British taxpayers who index their realized capital gains are those with the more complex transactions, according to British tax professionals, taxpayers generally cannot compute their gains without professional advice. The calculations are not particularly difficult for professionals and have increased the demand for professional tax preparers. Nevertheless, the tax administrators have found indexing difficult to administer, and reportedly compliance has suffered.[46] The United Kingdom frequently has adopted new legislation and regulations to combat the problem of arbitrage.

Further, with preferential capital gains treatment for some types of assets, depending upon the rate of inflation, taxpayers will have an incentive to engage in transactions designed to convert ordinary income to capital gains income. Thus, the complex provisions of present law dealing with situations in which capital gains treatment is available (for example, the collapsible partnership rules) will continue to be necessary.

Choice of price index

The rationale for indexing capital gains, and for the present-law indexing of various provisions of the Code, is to better measure the real income available to taxpayers. One price index that could be used to adjust basis for the purpose of computing gain is the Department of Commerce's Bureau of Economic Analysis's GDP deflator.[47] Another alternative index would be the Labor Department's Bureau of Labor Statistics's Consumer Price Index ("CPI"). The Code generally uses the CPI to index provisions related to in-

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[45] To the extent that lenders are in lower tax brackets than borrowers (the so-called "clientele effect"), the value of the tax deductions for interest claimed will exceed the value of taxes collected from interest income.

[46] As reported in Andrew Hoerner, "Indexing Capital Gains: The British Experience", *Tax Notes Today*, February 23, 1990.

[47] The U.S. Department of Commerce, Bureau of Economic Analysis, now more often refers to this measure as "the implicit price deflator for gross domestic purchases."

dividual taxpayers. Use of the CPI would provide consistency in the measurement of real income.

Recently, some economists have criticized the CPI as an accurate measure of consumer cost of living. The CPI is a fixed-basket price index. Given an identified basket of "consumer" goods, the CPI is estimated by comparing estimated prices for the "same" goods in one year compared to another year. Generally speaking, the CPI requires estimates of prices only. The purpose of measuring consumer purchases is to approximate consumer well-being. The primary drawback of a fixed-basket price index is that, through time, the basket may fail to represent consumer purchases. For example, if gas prices move higher, consumers may substitute public transportation for consumption of gasoline. An additional problem is identifying the "same" goods in different years, that is adjusting for quality changes. For example, one should not compare the average personal computer of 1997 with the average personal computer of 1990 as the average 1990 computer was much less powerful than the average 1997 computer.

The GDP deflator is not a fixed-basket price index. The GDP deflator is determined by estimating quantities of output of different goods in one year and identifying prices for those goods. Quantities of goods are then estimated for a subsequent year and prices are identified for those goods. The GDP deflator requires estimates of both quantities and prices. The GDP deflator will vary with the composition of GDP. As a measure tied to GDP, the GDP deflator also picks up certain international transactions, such as the value of U.S. goods sold abroad. One may not see such transactions as indicative of U.S. prices, but rather pricing conditions abroad. Similarly, the GDP deflator measures an economy average, including intermediate goods, and may not reflect inflation relevant to individual taxpayer purchases of consumer products. An alternative that uses the same methodology as the GDP deflator would be the Bureau of Economic Analysis's Implicit Price Deflator for Personal Consumption Expenditures.

An additional consideration may be the need to maintain some constancy to the index, as taxpayers may hold assets for 20 years or more before selling the asset. The CPI is never revised, save for identification of new base year baskets. Whatever technical improvements are made in the calculation of the index number are incorporated only for the computation of *future* index numbers. National income and product account data go through multiple revisions. The Bureau of Economic Analysis makes two subsequent monthly revisions to its price deflators, an annual revision, and every five years makes further revisions when it changes its benchmark year.

4. Capital Gains and Losses on Owner-Occupied Housing

Present law imposes tax on the gain from a sale of personal residence in limited circumstances. Critics of present law note that the disparate taxation of gain depending upon the disposition of proceeds or age of the taxpayer may distort taxpayer choice leading to inefficient outcomes. Assuming the principal residence is sold at a gain, because the taxpayer pays tax when he or she moves to a less expensive home, but not to a more expensive home, there is no incentive for the taxpayer to reduce the size of the housing they consume. This may cause taxpayers to invest more of their saving in owner-occupied housing and make less available for alternative investments such as plant and equipment. Similarly, present law may discourage the taxpayer from redeploying his or her assets from home ownership to other uses by becoming a renter. As discussed in Part II.D.2, above, the taxpayer may be "locked-in" to more home ownership than would be efficient for the economy. Critics of present law observe that because the tax can be avoided through deferral (sec. 1034) and the one-time exclusion (sec. 121), little revenue is collected on the sale of principal residences, so the efficiency losses to the economy are made in exchange for relatively little revenue gain. In addition, they note that there may be substantial noncompliance with present law. For example, in 1993 the National Association of Realtors reported 3.8 million home sales which is more than twice the amount of sales reported by taxpayers filing Form 2119.[48] Proposals that excluded all, or a substantial portion of, gain on the sale of a principal residence would mitigate these concerns.

Opponents of such changes counter that owner-occupied housing already is tax-favored. Some opponents believe that the favorable treatment accorded owner-occupied housing under present law has distorted aggregate investment towards housing and away from plant and equipment. They argue that an expansion of preferential treatment of gain on owner-occupied housing would increase inefficiency in investment decisions.

Proponents of permitting taxpayers to claim as capital loss any loss realized on the sale of their principal residence argue that because capital gains on a sale or exchange of a principal residence are taxable, losses on similar sales or exchanges should be treated as capital losses. As such losses represent a reduction in the taxpayer's wealth, it is also argued that the losses should be taken into account by the tax system to provide a better measure of economic income.

In response, it is argued that in practice many capital gains on the sale or exchange of principal residences are not taxed (e.g., through the operation of the sec. 1034 rollover provision and the sec. 121 one-time $125,000 exclusion for taxpayers aged 55 or over); therefore, capital losses on similar sales or exchanges should not be allowed. To permit recognition of losses would favor purchases of principal residences over other forms of investments that do not receive preferential taxation upon the payment of dividends or interest or recognition of gain. Another counter-argument is that not all economic losses are recognized for tax purposes. Taxpayers purchase homes, cars, and other consumer durable goods primarily for consumption purposes. Many losses arise from use and physical depreciation of such goods. For example, it is argued that if a taxpayer purchases a new car for $20,000 (for personal use) and sells

[48] Most observers believe that it is unlikely that half of that year's home sales occurred at a loss. Even if sold at a loss, taxpayers deferring recognition of gain under section 1034 should file Form 2119. For a discussion of inefficiencies created by present law, see Leonard E. Burman, Sally Wallace, and David Weiner, "How Capital Gains Taxes Distort Homeowners' Decisions," photocopy, November 14, 1996. Burman, Wallace, and Weiner estimate the extent to which present homeowners are discouraged from "downsizing."

it five years later for less than $20,000, he or she should not be allowed a capital loss.

5. Capital Loss Deduction Limit

Deductibility against ordinary income

The present limits on the deductibility of capital losses against ordinary income are intended to address problems that arise from the high degree of taxpayer discretion over when to sell certain types of assets. If capital losses were fully deductible against ordinary income, as was the case between 1921 and 1934, a taxpayer owning many assets could selectively sell only those assets with losses and thereby wipe out the tax on ordinary income even if those losses were offset by unrealized capital gains in the taxpayer's portfolio. This concern supports retention of a limitation on the deduction of capital or investment losses, even if capital or investment gains are not subject to preferential tax treatment and even though tax distinctions between investment and non-investment assets tend to generate disputes over the proper characterization of particular assets. Some have suggested a mark-to-market system (parallel to the present-law treatment of regulated futures contracts) for both gains and losses, at least in the case of publicly traded stock and securities or other readily valued assets. Others contend that limitation of such a system to these types of assets would retain possibilities for taxpayer manipulation.

Limits on the deductibility of capital losses may be unfair to taxpayers who have losses in excess of unrealized gains, since they may never get to deduct legitimate losses. Or, even if over a period of years the taxpayer can deduct the full loss, the present value of the deduction is reduced by deferral of the loss deduction. The reduction in the value of the loss deduction creates an asymmetric treatment of gains and losses. This relative penalty on loss deduction may discourage taxpayers from undertaking risky investments. However, the ability of the taxpayer to defer realization of his gains at his discretion creates incentives to undertake such investments.

The present system—allowing the deduction of losses against up to $3,000 of ordinary income—is a compromise between the desire to be fair to taxpayers with net losses and the need to protect the tax base from selective realization of losses. In effect, small investors, who are presumed not to have large portfolios with unrealized gains, are allowed to deduct capital losses against ordinary income, and large investors, for whom $3,000 is not significant, are not. Arguably, however, large investors may have larger portfolios and lower transactional costs, making it easier selectively to realize accrued gains to offset losses and reduce the adverse impact of the $3,000 limit.

Reduction of long-term capital loss carryovers

Prior law required that long-term losses be reduced by 50 percent when deducted against ordinary income (up to the $3,000 limit). That rule was also a compromise between the need to protect the tax base and equity to investors with net capital losses. If long-term losses were fully deductible against ordinary income, as was the case before 1969, taxpayers with both long-term gains and losses could realize the gains and losses in alternate years, paying tax on less than the full value of the gains and fully deducting the losses. Under prior law, a taxpayer who took care to realize losses before they became long-term could, of course, achieve this result despite the 50-percent reduction. To compensate for the loss limitation, Congress retained a 50-percent cutback, instead of increasing it to 60 percent, when the capital gains exclusion percentage was increased from 50 to 60 percent in 1978.

6. Distributional Effects of a Reduction in Capital Gains

Either an exclusion from income or indexing the basis of capital assets will benefit directly those taxpayers who hold assets with accrued capital gains. Information is somewhat scant regarding the distribution of assets with accrued capital gains among different taxpayers. Tax return data contain information on which taxpayers have realized capital gains in the past. These data reveal that many taxpayers realize a capital gain from time to time, but the majority of the dollar value of gains realized are by taxpayers who frequently realize capital gains. For example, the staff of the Joint Committee on Taxation studied a panel representative of the more than 15 million taxpayers who realized capital gains between 1979 and 1983. Approximately 44 percent of those taxpayers realized capital gains in only one year of that five-year period, and the gains realized by that 44 percent of taxpayers accounted for approximately 10 percent of the dollar value of gains realized. Taxpayers who realized gains in each of the five years comprised approximately 16 percent of the sample, but accounted for approximately 60 percent of the dollar value of gains realized.[49] Results of similar magnitude are found for at data for any one year. The staff of the Joint Committee on Taxation found that in 1985, 44 percent of all taxpayers who reported gains reported only one transaction and those transactions accounted for 21 percent of the dollar value of all gains realized in 1985. Consequently, nearly 80 percent of all gains realized in 1985 were realized by those taxpayers who realized more than one gain in that year.[50] Thus, while many taxpayers may benefit from an exclusion or indexing for capital gains, the bulk of the dollar value of any tax reduction will go to those taxpayers who realize the bulk of the dollar value of gains.

The data also suggest that taxpayers who infrequently realized capital gains generally have lower incomes than those taxpayers who frequently realized capital gains. These findings have been criticized because income is sometimes measured including the realized gain. However, attempts to account for this problem by measuring income less realized gains or by using a measure of income averaged over a period of years generally reveal that a large portion of the dollar value of gains are realized by higher-income taxpayers while a large portion of the transactions in which gains are realized are undertaken by the remaining taxpayers. Such findings are consistent with information on the ownership of assets in the United States. Higher-income taxpayers generally hold a larger

[49] Joint Committee on Taxation, *Explanation of Methodology Used to Estimate Proposals Affecting the Taxation of Income from Capital Gains* (JCS-12-90), March 27, 1990, pp. 48-49.
[50] Joint Committee on Taxation, *Explanation of Methodology*, p. 49.

proportion of corporate stock and other capital assets than do other taxpayers. Thus, while many taxpayers may benefit from an exclusion or indexing for capital gains, a larger proportion of the dollar value of any tax reduction will go to those higher-income taxpayers who realize the bulk of the dollar value of gains.

Although an exclusion and indexation of basis have similar economic effects, the distribution of expected benefits of the two proposals might be expected to differ somewhat. This is because an exclusion applies to the total gain, excluding from income both a portion of the inflationary gain and the real gain, while indexation only excludes the inflationary gain. If different taxpayers hold different assets and the assets experience different real returns, the benefits of an exclusion as compared to indexing will differ across different taxpayers. For example, older taxpayers may be more concerned with preservation of their principal and seek to hold less risky assets. Similarly, higher-income taxpayers generally are more willing to accept riskier investments. To compensate for risk, more risky assets generate, on average, higher returns than less risky assets. Such returns to risk are not inflationary returns but real returns. Indexing provides no tax benefit to such risk premiums earned by investors. All else being equal, an exclusion might be expected to offer greater tax benefits to higher-income taxpayers (who invest in more risky assets) than would indexing.

E. Appendix to Part II

Table A.1.—Distribution of Transactions and Gains By Asset Type For Transactions With Net Long-Term Gain, 1994, As Reported on Schedule D

Asset type	Number of transactions with net gain	Dollar value of net gains	Percentage of all transactions	Percentage of total value, of all gains
Corporate Stock	108,198	2,329,742,349	73.6	78.2
U.S. Government Obligations	4,239	30,681,504	2.9	1.0
State & Local Government Obligations	15,138	89,322,884	10.3	3.0
Other Bonds, Notes, & Debts	2,410	32,424,537	1.6	1.1
Put and Call Options	874	5,757,473	0.6	0.2
Commodities and Futures	(1)	(1)	(1)	(1)
Tax-Exempt Municipal Bond Funds	2,864	6,276,992	1.9	0.2
Interests in Partnerships/S Corps	1,488	221,587,471	1.0	7.4
Mutual Funds	8,255	49,741,609	5.6	1.7
Livestock	(1)	(1)	(1)	(1)
Timber	105	5,724,489	0.1	0.2
Invol. Conv. Other Than Casualties/Thefts	(1)	(1)	(1)	(1)
Residential Rental Property	510	35,058,048	0.3	1.2
Depreciable Business Personal Property	(1)	(1)	(1)	(1)
Depreciable Business Real Property	(1)	(1)	(1)	(1)
Land Other Than Farmland	1,164	82,227,427	0.8	2.8
Farmland and Ranches	(1)	(1)	(1)	(1)
Residences	(1)	(1)	(1)	(1)

Table A.1.—Distribution of Transactions and Gains By Asset Type For Transactions With Net Long-Term Gain, 1994, As Reported on Schedule D—Continued

Asset type	Number of transactions with net gain	Dollar value of net gains	Percentage of all transactions	Percentage of total value, of all gains
Other Assets	1,145	69,652,381	0.8	2.3
Unidentifiable Assets	522	19,643,541	0.4	0.7
Pass Through, Not Elsewhere Classified	(1)	(1)	(1)	(1)
Total	**146,912**	**2,977,840,705**	**100**	**100**

1 Fewer than 100 transactions; dollar amounts not disclosed.

Note.—Sample from Schedule D may not be representative of all gain recognitions.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service SOI data.

Table A.2.—Transactions With Long-Term Gains, By Holding Period, 1994, As Reported on Schedule D

Holding period in years—	Number of trans-actions	Dollar value of gains	Percent-age of total trans-actions	Percent-age of total value of gains
1–2	64,428	486,388,482	44.0	18.2
2–3	29,345	359,160,421	20.0	13.4
3–4	15,421	249,850,605	10.5	9.3
4–5	9,345	153,370,504	6.4	5.7
5–6	6,089	123,891,319	4.2	4.6
6–7	4,818	147,468,480	3.3	5.5
7–8	3,084	181,272,115	2.1	6.8
8–9	2,357	88,066,537	1.6	3.3
9–10	2,844	129,482,931	1.9	4.8
10–11	2,154	89,853,595	1.5	3.4
11–12	1,021	39,410,985	0.7	1.5
12–13	740	33,912,789	0.5	1.3
13–14	623	39,223,290	0.4	1.5
14–15	595	45,527,637	0.4	1.7
15–16	391	15,674,162	0.3	0.6
16–17	270	29,080,531	0.2	1.1
17–18	251	21,981,705	0.2	0.8
18–19	261	23,990,520	0.2	0.9
19–20	239	10,790,886	0.2	0.4
20+	2,274	406,686,449	1.6	15.2
Totals	**146,550**	**2,675,083,943**	**100.0**	**100**

Note.—Sample from Schedule D may not be representative of all gain recognitions.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service SOI data.

Table A.3.—Transactions With Capital Losses By Holding Period, 1994, As Reported on Schedule D

Holding period in years—	Number of loss transactions	Dollar value of losses	Number of transactions percentage	Dollar value of transactions percentage
1–2	56,828	449,941,281	55.5	35.6
2–3	20,259	206,118,499	19.8	16.3
3–4	8,065	104,203,849	7.9	8.2
4–5	4,944	73,006,333	4.8	5.8
5–6	3,133	100,663,605	3.1	8.0
6–7	2,398	62,209,894	2.3	4.9
7–8	1,817	50,750,354	1.8	4.0
8–9	1,245	57,061,087	1.2	4.5
9–10	886	24,980,927	0.9	2.0
10–11	638	50,418,466	0.6	4.0
11–12	492	10,259,088	0.5	0.8
12–13	205	10,266,616	0.2	0.8
13–14	186	11,458,411	0.2	0.9
14–15	196	27,161,379	0.2	2.1
15–16	127	1,754,878	0.1	0.1
16–17	102	1,329,719	0.1	0.1
17–18	62	1,454,582	0.1	0.1
18–19	64	4,596,337	0.1	0.4
19–20	64	2,215,849	0.1	0.2
20+	646	14,188,061	0.6	1.1
Totals	**102,357**	**1,264,039,215**	**100**	**100**

Note.—Sample from Schedule D may not be representative of all loss recognitions.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service SOI data.

III. INDIVIDUAL RETIREMENT ARRANGEMENTS ("IRAS")

A. Present Law And Legislative Background

1. Individual Retirement Arrangements ("IRAs")

a. Present-law rules for IRAs

In general

Under certain circumstances, an individual is allowed a deduction for contributions (within limits) to an individual retirement account or an individual retirement annuity (an "IRA") (sec. 219). An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. No deduction is permitted with respect to contributions made to an IRA for a taxable year after the IRA owner attains age 70½.

Under present law, the maximum deductible contribution that can be made to an IRA generally is the lesser of $ 2,000 or 100 percent of an individual's compensation (earned income in the case of self-employed individuals). A married taxpayer who files a joint return with his or her spouse is permitted to make the maximum deductible IRA contribution of up to $2,000 for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

A single taxpayer is permitted to make the maximum deductible IRA contribution for a year if the individual is not an active participant in an employer-sponsored retirement plan for the year or the individual has adjusted gross income ("AGI") of less than $25,000. A married taxpayer filing a joint return is permitted to make the maximum deductible IRA contribution for a year if neither spouse is an active participant in an employer-sponsored plan or the couple has combined AGI of less than $40,000.

If a single taxpayer or either spouse (in the case of a married couple) is an active participant in an employer-sponsored retirement plan, the maximum IRA deduction is phased out over certain AGI levels. For single taxpayers, the maximum IRA deduction is phased out between $25,000 and $35,000 of AGI. For married taxpayers, the maximum deduction is phased out between $40,000 and $50,000 of AGI. In the case of a married taxpayer filing a separate return, the deduction is phased out between $0 and $10,000 of AGI.[51]

An individual is an active participant in an employer-sponsored retirement plan for the taxable year if the individual is an active

[51] A couple is not considered married for purposes of the IRA deduction rules if the individuals file separate returns and live apart from one another at all times during the taxable year; each spouse is treated as a single individual in such a case.

participant for the plan year ending with or within the individual's taxable year. An employer-sponsored retirement plan means (1) a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)); (2) a qualified annuity plan (sec. 403(a)); (3) a simplified employee pension plan (sec. 408(k)); (4) any SIMPLE retirement account (sec. 408(p)); (5) a plan established for its employees by the U.S., by a State or political subdivision, or by any agency or instrumentality of the U.S. or a State or political subdivision (other than a deferred compensation plan of a State or local government (sec. 457)); (6) a plan described in section 501(c)(18); and (7) a tax-sheltered annuity (sec. 403(b)).

The determination of whether an individual is an active participant depends on the type of plan involved. In general, in the case of a defined benefit pension plan, an individual is treated as an active participant if the individual is eligible to participate in the plan. An individual is an active participant in a defined contribution plan only if any amounts are allocated to the account of the participant for the year.[52] The extent to which a person is vested in his or her benefits under an employer-sponsored plan is not taken into account under the active participant rules.

Nondeductible IRA contributions

Individuals may make nondeductible IRA contributions to the extent deductible contributions are not allowed because of the AGI phaseout and active participant rules. A taxpayer may also elect to make nondeductible contributions in lieu of deductible contributions. Thus, any individual may make nondeductible contributions up to the excess of (1) the lesser of $2,000 or 100 percent of compensation over (2) the IRA deduction claimed by the individual. An individual making nondeductible contributions is required to report the amount of such contributions on his or her tax return. As is the case with earnings on deductible IRA contributions, earnings on nondeductible contributions are not subject to income tax until withdrawn. Nondeductible IRAs provide the same tax benefit as deferred annuities. However, there are no limits on the amount that can be contributed to the purchase of a deferred annuity.

Taxation of withdrawals

Amounts withdrawn from IRAs (other than amounts that represent a return of nondeductible contributions) are includible in income when withdrawn. If an individual withdraws an amount from an IRA during a taxable year and the individual has previously made both deductible and nondeductible IRA contributions, then the amount includible in income for the taxable year is the excess of the amount withdrawn over the portion of the amount withdrawn attributable to investment in the contract (i.e., nondeductible contributions). The amount attributable to nondeductible contributions is the portion of the amount withdrawn that bears the same ratio to the amount withdrawn as the total amount of nondeductible contributions bears to the total current value of all IRAs of the individual.

[52] The definition of active participant under present law is generally the same as the definition of active participant that applied for purposes of determining eligibility to make IRA contributions prior to the IRA amendment adopted in the Economic Recovery Tax Act of 1981.

To discourage the use of amounts contributed to an IRA for non-retirement purposes, withdrawals from an IRA prior to age 59½ are subject to an additional 10-percent income tax, unless the withdrawal is made (1) on account of death or disability, (2) in the form of annuity payments, (3) for medical expenses of the individual and his or her spouse and dependents that exceed 7.5 percent of AGI or (4) for medical insurance of the individual and his or her spouse and dependents (without regard to the 7.5 percent of AGI floor) if the individual has received unemployment compensation for at least 12 weeks, and the withdrawal is made in the year such unemployment compensation is received or the following year. If a self-employed individual is not eligible for unemployment compensation under applicable law, then to the extent provided in regulations, a self-employed individual is treated as having received unemployment compensation for at least 12 weeks if the individual would have received unemployment compensation but for the fact that the individual was self-employed. The exception to the additional tax ceases to apply if the individual has been reemployed for at least 60 days. The 10-percent additional income tax is intended to recapture at least a portion of the tax benefit of the IRA. A similar early withdrawal tax applies to withdrawals from qualified retirement plans and deferred annuities.

For years after 1999, a 15-percent excise tax is imposed on excess distributions with respect to an individual during any calendar year from qualified retirement plans, tax-sheltered annuities, and IRAs.[53] The purpose of the tax is to limit the total amount that can be accumulated on behalf of a particular individual on a tax-favored basis. In enacting the excise tax, Congress believed that an individual should not be permitted to accumulate excessive retirement savings, regardless of whether such excess was attributable to the receipt of multiple maximum benefits from several employers, very large appreciation in defined contribution plans, or the use of IRAs by individuals receiving significant employer-provided benefits.

In general, excess distributions are defined as the aggregate amount of retirement distributions (i.e., payments from applicable retirement plans) made with respect to an individual during any calendar year to the extent such amounts exceed $160,000 (for 1997). The dollar limit is indexed for inflation. Special rules apply in the case of lump-sum distributions and post-death distributions.

b. Legislative background of IRAs

Employee Retirement Income Security Act of 1974

The individual retirement savings provisions of the Internal Revenue Code were originally enacted in the Employee Retirement Income Security Act of 1974 ("ERISA") to provide a tax-favored retirement savings arrangement to individuals who were not covered under a tax-qualified retirement plan maintained by an employer. Individuals who were active participants in employer-sponsored retirement plans were not permitted to make contributions to an

[53] The excise tax on excess distributions was enacted as part of the Tax Reform Act of 1986, effective with respect to distributions made after December 31, 1996. The Small Business Job Protection Act of 1996 suspended the excise tax on excess distributions for 1997, 1998, and 1999.

IRA. As enacted in ERISA, the limit on the deduction for IRA contributions was generally the lesser of (1) 15 percent of the individual's compensation (earned income in the case of a self-employed individual) for the year, or (2) $1,500.

Economic Recovery Tax Act of 1981

The Economic Recovery Tax Act of 1981 ("ERTA") increased the deduction limit for contributions to IRAs and removed the restrictions on IRA contributions by active participants in employer-sponsored retirement plans. After ERTA, the deduction limit for IRAs was generally the lesser of (1) 100 percent of the individual's compensation (earned income in the case of a self-employed individual), or (2) $2,000. Any individual was entitled to make a deductible contribution to an IRA even if the individual was an active participant in an employer-sponsored retirement plan.

The ERTA changes were motivated by Congressional concern that a large number of workers, including many who were covered by employer-sponsored retirement plans, faced the prospect of retirement without the resources needed to provide adequate retirement income levels. The Congress concluded that retirement savings by individuals during their working years can make an important contribution towards providing retirement income security.

Tax Reform Act of 1986

The Tax Reform Act of 1986 ("1986 Act") added the present-law restrictions on deductible IRA contributions by active participants in employer-sponsored retirement plans. These restrictions are similar to those originally included in ERISA. In addition, the 1986 Act added the present-law rules permitting individuals to make nondeductible contributions to an IRA.

These changes were made because Congress determined at the time that the expanded availability of IRAs had no discernible impact on the level of aggregate personal saving. In addition, Congress believed that the wide availability of the option to make elective deferrals under cash or deferred arrangements and tax-sheltered annuities reduced the prior concern that individuals in employer-maintained retirement plans should be able to save additional amounts for retirement on a discretionary basis. Congress was also concerned that data had shown that IRA utilization was low among lower-income taxpayers and that taxpayers for whom IRA utilization was the largest would generally have saved without regard to the tax incentives. However, Congress also wished to provide a tax incentive for discretionary retirement savings for all taxpayers and therefore permitted all taxpayers to make nondeductible IRA contributions.

Small Business Job Protection Act of 1996

The Small Business Job Protection Act of 1996 ("1996 Act") modified the rule relating to the maximum deductible IRA contribution by permitting deductible IRA contributions of up to $2,000 to be made for each spouse (including a spouse who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount. Prior to the 1996 Act, the maximum annual contribution that could be made for a nonworking spouse was $250. This change was made because Congress was concerned about the national savings rate, and believed that individuals should be encouraged to save. The Congress believed that the ability to make deductible contributions to an IRA is a significant savings incentive. However, this incentive was not available to all taxpayers under prior law. The Congress believed that the prior-law rules relating to deductible IRAs penalized American homemakers. The Congress believed that IRA contributions should be permitted for both spouses even though only one spouse works.

Health Insurance Portability and Accountability Act of 1996

The Health Insurance Portability and Accountability Act of 1996 ("HIPA") modified the 10-percent early withdrawal tax for certain IRA distributions to provide that the tax does not apply to withdrawals from IRAs (1) for medical expenses of the individual and his or her spouse and dependents in excess of 7.5 percent of AGI and (2) for medical insurance of the taxpayer and his or her spouse and dependents (without regard to the 7.5 percent of AGI floor) in the case of individuals who have been receiving unemployment compensation for at least 12 weeks.

2. Qualified Retirement Plans

In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though the contributions are not currently included in an employee's income. Contributions to a qualified plan are held in a tax-exempt trust.

Employees, as well as employers, may make contributions to a qualified plan. Employees may, subject to certain restrictions, make both pre-tax and after-tax contributions to a qualified plan. Pre-tax employee contributions (e.g., contributions to a qualified cash or deferred arrangement (sec. 401(k) plan)) are treated the same as employer contributions for tax purposes.

The tax treatment of contributions under qualified plans is essentially the same as that of present law IRAs. However, the limits on contributions to qualified plans are much higher than the IRA contribution limits, so that qualified plans provide for a greater accumulation of funds on a tax-favored basis. The policy rationale for permitting greater accumulation under qualified plans than IRAs is that the tax benefits for qualified plans encourage employers to provide benefits for a broad group of their employees. This reduces the need for public assistance and reduces pressure on the social security system.

The qualification standards and related rules governing qualified plans are designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as highly compensated employees. They also define the rights of plan participants and beneficiaries and provide some limits on the tax benefits for qualified plans.[54] Certain of the rules relating to qualified plans are designed to ensure that the amounts contributed to qualified plans are used for retirement purposes. Thus, for example, an early withdrawal tax applies to premature distributions from such plans, and the ability to obtain distributions prior to termination of employment from certain types of qualified plans is restricted.

Types of qualified plans

Qualified plans are broadly classified into two categories, defined benefit pension plans and defined contribution plans, based on the nature of the benefits provided.

Under a defined benefit pension plan, benefit levels are specified under a plan formula. For example, a defined benefit pension plan might provide an annual retirement benefit of 2 percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan. Benefits under a defined benefit pension plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation ("PBGC"), a federal corporation within the Department of Labor.

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Profit-sharing plans and qualified cash or deferred arrangements (called 401(k) plans after the section of the Code regulating such plans) are examples of defined contribution plans.

Limits on contributions and benefits

Under present law, limits apply to contributions and benefits under qualified plans. In the case of a defined benefit pension plan, present law limits the annual benefits payable under the plan to the lesser of (1) 100 percent of the participant's average compensation for his or her high 3 years, or (2) $125,000 (for 1997).[55] Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) $30,000. Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The dollar limits are increased for cost-of-living adjustments in $5,000 increments.

An overall limit applies if an individual is a participant in both a defined contribution plan and a defined benefit plan of the same employer. The Small Business Job Protection Act of 1996 repealed this overall limit for years beginning after December 31, 1999.

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[54] Qualified plans are subject to regulation under Federal labor laws (Title I of Employee Retirement Income Security Act of 1974 (ERISA)) as well as under the Internal Revenue Code. The ERISA rules generally relate to rights of plan participants and the obligations of plan fiduciaries.

[55] Annual benefits may in some cases exceed this dollar limitation under grandfather and transition rules contained in the Tax Equity and Fiscal Responsibility Act of 1982 and other legislation.

Taxation of distributions

Under present law, a distribution of benefits from a qualified plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents the employee's investment in the contract (i.e., basis). Special rules apply to lump-sum distributions, distributions rolled over to an IRA, and distributions of employer securities.

Early distributions from qualified plans generally are subject to the same additional 10-percent early withdrawal tax that applies to early distributions from IRAs. However, certain additional exceptions to the tax apply. For example, the early withdrawal tax does not apply to distributions made to an employee after separation from service after attainment of age 55. Qualified plan distributions are also subject to the excess distribution tax applicable to IRA distributions.[56]

Qualified cash or deferred arrangements

As mentioned above, a qualified cash or deferred arrangement is a type of qualified pension plan. Thus, such arrangements are subject to the rules generally applicable to qualified pension plans. In addition, special rules apply to such arrangements.

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a qualified plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is $9,500 for 1997. This dollar limit is indexed for inflation in $500 increments. An employee's elective deferrals must be fully vested. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements. Employer matching contributions and after-tax employee contributions under qualified defined contribution plans are also subject to a special nondiscrimination test.

3. SIMPLE Retirement Plans

Under present law, certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans can be adopted by employers who employ 100 or fewer employees who received at least $5,000 in compensation during the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an IRA for each employee or part of a qualified cash or deferred arrangement ("401(k) plan"). If established in IRA form, a SIMPLE plan is not subject to the nondiscrimination rules generally applicable to qualified plans (including the top-heavy rules) and simplified reporting requirements apply. Within limits, contributions to a SIMPLE plan are not taxable until withdrawn.

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[56] This excess distribution tax is suspended for 1997 through 1999.

A SIMPLE plan can also be adopted as part of a 401(k) plan. In that case, the plan does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified plan rules continue to apply.

A SIMPLE retirement plan allows employees to make elective contributions which cannot exceed $6,000 per year. The $6,000 dollar limit is indexed for inflation in $500 increments. The employer is required to satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation. Under a special rule applicable to a SIMPLE IRA, the employer can elect a lower percentage matching contribution for all employees (but not less than 1 percent of each employee's compensation). In addition, a lower percentage cannot be elected for more than 2 out of any 5 years.

Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a 2 percent of compensation nonelective contribution on behalf of each eligible employee with at least $5,000 in compensation for such year, whether or not the employee makes an elective contribution.

In order for the employer to lower the matching percentage, (in the case of a SIMPLE IRA), or to make a nonelective contribution for any year, the employer has to notify employees of the applicable match within a reasonable time before the 60-day election period for the year. The 60-day election period is the period within which each eligible employee can elect to participate in the SIMPLE plan and modify any previous elections regarding the amount of contributions. The 60-day period is the 60-day period before the beginning of any year or the 60-day period before an employee first becomes eligible to participate.

No contributions other than employee elective contributions, required employer matching contributions or employer nonelective contributions can be made to a SIMPLE plan. All contributions to an employee's SIMPLE account must be fully vested.

Contributions to a SIMPLE plan generally are deductible by the employer and excludable from the employee's income. Early withdrawals from a SIMPLE plan generally are subject to the 10-percent early withdrawal tax. However, in the case of a SIMPLE IRA, withdrawals of contributions during the 2-year period beginning on the date the employee first participated in the SIMPLE IRA are subject to a 25-percent early withdrawal tax.

4. Simplified Employee Pensions ("SEPs")

Under present law, certain employers (other than tax-exempt and governmental employers) can establish a simplified employee pension (SEP) for the benefit of their employees. A SEP is an IRA which may receive contributions from the employer in an amount that is greater than the normal IRA deduction limits. The employee is always 100-percent vested in employer contributions. SEPs are generally subject to the same rules that apply to IRAs. In addition, certain other rules apply. Each employee who (1) has attained age 21, (2) has performed services for the employer during at least 3 of the immediately preceding 5 years, and (3) received at least $400 (for 1997) in compensation from the employer for the year. An employee can participate even though he or she is also a participant in one or more other qualified retirement plans sponsored by the employer. However, SEP contributions are added to the employer's contribution to the other plans on the participant's behalf in applying the limits on contributions and benefits (sec. 415).

Effective for taxable years beginning after December 31, 1996, employers can no longer establish a salary reduction SEP ("SARSEP") under which the employees can elect to have contributions made to the plan or to receive the contributions in cash (sec. 408(k)(6)). However, employers may continue to make contributions, under rules in effect prior to January 1, 1997, to SARSEPs that were established before 1997. In addition, employees hired after December 31, 1996, may participate in SARSEPs established by their employers prior to January 1, 1997.

5. Other Tax Incentives for Saving

Tax-sheltered annuities

Tax-sheltered annuities are another form of employer-based retirement plan that provide the same tax benefits as qualified plans and IRAs. Employers may contribute to such annuities on behalf of their employees, and employees may contribute on a pre-tax basis through salary reduction. Tax-sheltered annuities are subject to rules similar to some of the rules applicable to qualified plans. Tax-sheltered annuity plans may be maintained only by certain types of organizations, in particular, tax-exempt charitable organizations and educational institutions.

Annuity contracts

Present law provides that income credited to a deferred annuity contract is not currently includible in the gross income of the owner of the contract nor is the income taxed to the insurance company issuing the contract. No deduction is provided for, and no dollar limits are imposed on, amounts used to purchase annuity contracts. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under or secured by the contract) are includible in gross income as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. In addition, a portion of each distribution received after the annuity starting date is treated as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

A 10-percent additional income tax is imposed on certain early withdrawals under an annuity contract. This additional tax does not apply to any distribution made after the owner of the contract attains age 59½, receives annuity payments under the contract, or satisfies certain other requirements.

Life insurance

Under present law, the investment income ("inside buildup") earned on premiums credited under a life insurance policy generally is not subject to current taxation to the owner of the policy or to the insurance company issuing the contract. This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract. The contract must satisfy the statutory definition of life insurance by meeting either of two statutory tests: the "cash value accumulation" test, or the "guideline premium/cash value corridor" test.

No deduction is provided for, and no dollar limits are imposed on, amounts used by an individual to purchase life insurance contracts.

Death benefits paid under a life insurance contract are excluded from income, so that neither the policyholder nor the policyholder's beneficiary is ever taxed on the inside buildup if the proceeds of the policy are paid to the policyholder's beneficiary by reason of the death of the insured.

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income only to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income. In the case of a modified endowment contract, however, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances.

B. Description of Proposals

1. IRA Provisions Contained in the President's Fiscal Year 1998 Budget Proposal

In general

In general, the President's budget proposal would: (1) increase the present-law income limits (in two steps) on deductible IRA contributions and increase the income phase-out range to $20,000 (so that, for married taxpayers in 1997, 1998, and 1999, the income phase-out range would be $70,000 to $90,000 of AGI, and $80,000 to $100,000 thereafter; and for single taxpayers in 1997, 1998, and 1999, the income phase-out range would be $45,000 to $65,000 of AGI, and $50,000 to $70,000 thereafter); (2) index the $2,000 IRA contribution limit and the income limits; (3) coordinate the IRA contribution limit with the elective deferral limit; (4) create nondeductible tax-free IRAs called "Special IRAs;" and (5) provide an exception from the 10-percent early withdrawal tax for IRA distributions used for higher education expenses, first-time homebuyer expenses, medical expenses (in excess of 7.5 percent of AGI) of the individual's child, grandchild, parent or grandparent regardless of whether such person is a dependent of the individual, and distributions for any reason to individuals who have been receiving unemployment compensation for at least 12 weeks. The proposal would also provide that IRA assets can be invested in qualified State tuition program instruments.

Deductible IRA contributions

The proposal would increase the income limits at which the maximum IRA deduction is phased out for active participants in employer-sponsored retirement plans in two steps. For married taxpayers in 1997, 1998, and 1999, the income phase-out range would be $70,000 to $90,000 of AGI, and $80,000 to $100,000 thereafter. For single taxpayers in 1997, 1998, and 1999, the income phase-out range would be $45,000 to $65,000 of AGI, and $50,000 to $70,000 thereafter. The income thresholds would be indexed for inflation, beginning after 2000.

The IRA deduction limit would be coordinated with the limit on elective deferrals so that the maximum allowable IRA deduction for a year could not exceed the excess of the elective deferral limit over the amount of elective deferrals made by the individual.

The proposal would provide that the exception to the early withdrawal tax for distributions after age 59½ does not apply to amounts that have been held in an IRA for less than 5 years.

Inflation adjustment for IRA contribution limit

The $2,000 IRA deduction limit would be indexed for inflation for taxable years beginning after 1997.

Nondeductible contributions to tax-free Special IRAs

Under the proposal, individuals who are eligible to make deductible IRA contributions also would be eligible to make nondeductible contributions to a Special IRA. Special IRAs generally would be treated the same as IRAs, but also would be subject to special rules. The IRA deduction limit and the limit on contributions to Special IRAs would be coordinated. Thus, the maximum contribution that could be made in a year to a Special IRA would be the excess of the IRA deduction limit applicable to the individual over the amount of the individual's deductible IRA contributions. Distributions from Special IRAs would not be includible in income to the extent attributable to contributions that had been in the Special IRA for at least five years. Withdrawals of earnings from Special IRAs during the 5-year period after contribution would be subject to income tax, and also would be subject to the 10-percent tax on early withdrawals unless used for one of the special purposes described below (or unless a present-law exception to the tax, other than the exception for distributions after age 59½, applies).

An individual whose AGI for a year does not exceed $100,000 for married taxpayers and $70,000 for single taxpayers could convert an existing IRA into a Special IRA without being subject to the 10-percent tax on early withdrawals. The amount transferred from the deductible IRA to the Special IRA generally would be includible in the individual's income in the year of the transfer.[57] However, if a transfer is made before 1999, the amount to be included in the individual's income with respect to the transfer would be spread evenly over four taxable years.[58]

[57] The amount transferred would not be included in the taxpayer's AGI for purposes of applying the income limits on IRA contributions to the taxpayer for the year of transfer.

[58] In the case of such a transfer before 1999, the amount of such transfer would also be taken into account for purposes of the 15-percent excise tax on excess distributions ratably over a four-year period.

Special purpose withdrawals

The proposal would provide exceptions to the 10-percent early withdrawal tax for distributions from IRAs or Special IRAs used for certain special purposes. Penalty-free withdrawals would be withdrawals (1) for qualified higher education expenses of the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild (whether or not a dependent), (2) for acquisition of a principal residence for a first-time homebuyer who is the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild, (3) for medical expenses (in excess of 7.5 percent of AGI) of the individual's child, grandchild, parent or grandparent, whether or not that person otherwise qualifies as the individual's dependent, and (4) made by individuals who have been receiving unemployment compensation for at least 12 consecutive weeks.

Investment in qualified State tuition program instruments

The proposal would provide that any IRA assets can be invested in qualified State tuition program instruments. To the extent the instrument is converted into tuition and fees, the account holder would be treated as receiving a distribution equal to the cost of such tuition and fees as of the time of the conversion. Further, such a deemed distribution would be treated as a special purpose withdrawal for qualified higher education expenses, and thus would not be subject to the 10-percent additional tax on early withdrawals. The tax treatment of the deemed distribution would depend on whether the instrument is held by an IRA or a Special IRA.

Effective date

The proposal would generally be effective on January 1, 1997. The IRA provisions sunset after December 31, 1999.

2. The "Savings and Investment Incentive Act of 1997" (H.R. 446) (Mr. Thomas and others) [59]

IRA deduction limits (sec. 101 of the bill)

The bill would increase the AGI limits applicable to deductible IRA contributions for active participants in 1997, 1998, 1999, and 2000. Thereafter, the bill would repeal the limits on IRA deductions for active participants in employer-sponsored retirement plans. Thus, under the bill, after 2000, an individual would be entitled to make a $2,000 deductible IRA contribution without regard to whether the individual was an active participant in an employer-sponsored retirement plan.

In the case of married taxpayers filing a joint return, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $65,000 and $75,000; for 1998, $90,000 and $100,000; for 1999, $115,000 and $125,000; and for 2000, $140,000 and $150,000.

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[59] H.R. 446 was introduced on January 29, 1997, by Mr. Thomas, Mr. Neal (Massachusetts), Mr. Ensign, Mr. Bereuter, Mr. English (Pennsylvania), Mr. Gejdenson, Mr. McIntosh, Mr. Livingston, Mr. Ehrlich, Mr. Herger, Mr. McGovern, Mr. Frost, Mr. Cook, Mrs. Emerson, Ms. Dunn, Mr. Crane, Mr. Graham, Mr. Green, Mr. McCrery, Mr. Saxton, Mr. Barrett (Nebraska), and Mr. Bartlett (Maryland).

In the case of single taxpayers, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $50,000 and $60,000; for 1998, $75,000 and $85,000; for 1999, $100,000 and $110,000; and for 2000, $125,000 and $135,000.

Deductible IRAs available for nonworking spouses (sec. 101(a)(2) of the bill)

Under the bill, an individual would not be considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is such an active participant. Thus, the bill would permit a nonworking spouse to make a deductible IRA contribution of up to $2,000 without regard to the present-law income phaseouts.

Indexing of IRA contribution limit (sec. 102 of the bill)

The bill would index the $2,000 IRA contribution limit in multiples of $500 after 1997.

Coins and bullion not treated as collectibles (sec. 103 of the bill)

Under the bill, the definition of coins eligible for the present-law exception for IRA assets invested in collectibles would be amended. Thus, the bill would define a coin eligible for the exception as (1) any coin certified by a national grading service and traded on a nationally recognized electronic network, or listed by a recognized wholesale reporting service and was legal tender in the country of issuance or was issued under the laws of any State and (2) any gold, silver, platinum, or palladium bullion (whether fabricated in the form of a coin or not) of a fineness equal to or exceeding the maximum fineness required for metals that may be delivered in satisfaction of a regulated futures contract subject to regulation by the Commodity Futures Trading Commission under the Commodity Exchange Act. The bill would require that the coin or bullion be in the physical possession of the IRA trustee.

Nondeductible contributions to tax-free IRA Plus accounts (sec. 111 of the bill)

The bill would permit taxpayers to make nondeductible contributions to new IRA Plus accounts. Generally, IRA Plus accounts would be treated in the same manner as and be subject to the same rules applicable to deductible IRAs. However, a number of special rules would apply.

Contributions to an IRA Plus account would be nondeductible. The amount of nondeductible contributions to an IRA Plus account that could be made for any taxable year would be tied to the limits for deductible IRAs, so that the aggregate amount of contributions to an IRA Plus account could not exceed the excess of (1) the IRA deduction limit for the year (determined without regard to the rule coordinating the IRA deduction limit with the elective deferral limit) over (2) the amount of IRA contributions actually deducted for the year.

Under the bill, any qualified distribution from an IRA Plus account would not be included in gross income and would not be subject to the 10-percent additional income tax on early withdrawals. A qualified distribution from an IRA Plus account would include any payment or distribution (1) made on or after the date the IRA Plus owner attains age 59½, (2) made to a beneficiary of the IRA Plus owner after death, (3) on account of disability of the IRA Plus owner, or (4) which is a qualified special purpose distribution (i.e., a distribution for first-time home purchase, medical expenses, long-term unemployment, and higher education expenses).

The bill provides that a distribution would not be treated as a qualified distribution if it is made within the 5-taxable year period beginning with the first taxable year for which the individual made a contribution to an IRA Plus account (or such individual's spouse made a contribution to an IRA Plus account). In addition, the bill provides that a distribution would not be treated as a qualified distribution if, in the case of a distribution attributable to a qualified rollover contribution, the distribution is made within the 5-taxable year period beginning with the taxable year in which the rollover contribution was made.

In the case of a distribution from an IRA Plus account that is not a qualified distribution, in applying the rules of section 72, the distribution would be treated as made from contributions to the IRA Plus account to the extent that such distribution, when added to all previous distributions from the IRA Plus account, does not exceed the aggregate amount of contributions to the IRA Plus account. Thus, nonqualified distributions from an IRA Plus account would not be included in income (and subject to the additional 10-percent tax on early withdrawals) until the IRA owner had withdrawn amounts in excess of all contributions to the IRA Plus account.

Rollover contributions would be permitted to an IRA Plus only to the extent such contributions consist of a payment or distribution from another IRA Plus or from an individual retirement plan. Such rollover contributions would not be taken into account in determining the contribution limit for a taxable year. The normal IRA rollover rules would otherwise govern the eligibility of withdrawals from IRA Plus accounts to be rolled over.

The bill would permit amounts withdrawn from IRAs to be transferred into an IRA Plus. The amount transferred would be includible in gross income in the year the withdrawal was made, except that amounts transferred to an IRA Plus before January 1, 1999, would be includible in income ratably over a 4-year period. The 10-percent early withdrawal tax would not apply to amounts transferred from an IRA to an IRA Plus account.

Under the bill, the excise tax on excess distributions from qualified retirement plans (sec. 4980A) would not apply to distributions from an IRA Plus account or to any qualified rollover contribution from an individual retirement plan to an IRA Plus account.

The provisions of the bill relating to IRA Plus accounts would be effective for taxable years beginning after December 31, 1996.

IRA withdrawals for first-time home purchase, long-term unemployment, post-secondary education expenses, and qualified medical expenses (sec. 201 of the bill)

The bill would permit withdrawals to be exempt from the 10-percent additional tax on early withdrawals (sec. 72(t)) if made (1) for a qualified first-time homebuyer; (2) in the event of long-term unemployment, for any reason; (3) for the post-secondary education expenses of the individual, the spouse of the individual, or a dependent child of the individual or the individual's spouse; and (4) in the case of distributions for medical purposes, for a child, grandchild, or ancestor of the individual or the individual's spouse (regardless of whether such person is a dependent of the individual).

A qualified first-time homebuyer distribution would mean any distribution received by an individual if it is used within 60 days to pay qualified acquisition costs with respect to a principal residence of a first-time homebuyer who is the individual, the individual's spouse, or any child, grandchild, or ancestor of the individual or the individual's spouse. Qualified acquisition costs include the costs of acquiring, constructing, or reconstructing a residence and any usual or reasonable settlement, financing, or other closing costs. An individual generally is a first-time homebuyer if the individual (and the individual's spouse, if married) did not have an ownership interest in a principal resident during the 2-year period ending on the date of acquisition of the principal residence.

For purposes of this provision, long-term unemployment has the same meaning as under present law (i.e., the individual has received unemployment compensation for at least 12 weeks).

For purposes of this provision, qualified higher education expenses would be defined as tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution. The amount of qualified higher education expenses would be reduced by any amount excluded from income upon redemption of a qualified U.S. savings bond (sec. 135).[60]

The provision would be effective for distributions after December 31, 1996.

3. IRA Provisions Contained in the "Balanced Budget Act of 1995" (H.R. 2491, 104th Cong.) (the "BBA")

Restoration of IRA deduction (sec. 11011 of the BBA)

Under the BBA, the income limits at which the maximum IRA deduction would have been phased out for active participants would increase in increments each year until 2007. For married taxpayers, the deduction would be phased out over a $20,000 income range, increased in $2,500 increments until the phase-out range is $100,000 to $120,000 (in 2007). For single taxpayers, the deduction would be phased out over a $10,000 income range, increased in $5,000 increments until the phase-out range is $85,000 to $95,000 (in 2007). The income thresholds would be indexed for inflation beginning after 2007. The $2,000 limit on deductible IRA contributions would be indexed for inflation beginning after 1996.

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60 The BBA was passed by the 104th Congress and vetoed by President Clinton.

The provision increasing the income limits would have been effective for taxable years beginning after December 31, 1996. Indexing of the $2,000 IRA deduction limit would have been effective for taxable years beginning after December 31, 1996.

Definition of active participant (sec. 11013 of the BBA)

An individual would not be considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is such an active participant.[61]

The provision would have been effective for taxable years beginning after December 31, 1995.

Nondeductible contributions to tax-free American Dream IRA (sec. 11015 of the BBA)

An individual would have been permitted to make contributions to an American Dream IRA ("AD IRA") to the extent he or she does not make deductible contributions to an IRA. The active participant rule would be disregarded in determining the maximum deductible IRA contribution. The income limits applicable to deductible IRAs would not apply to AD IRAs. Contributions could be made to an AD IRA after age 70½ and the pre-death minimum distribution rules would not apply.

An individual could convert an IRA to an AD IRA. The amount transferred to an AD IRA before January 1, 1998, would be includible in gross income ratably over a 4-year period. The 10-percent early withdrawal tax would not apply to amounts converted to an AD IRA.

Under the BBA, any qualified distribution from an AD IRA would not be included in gross income and would not be subject to the 10-percent early withdrawal tax. A qualified distribution from an AD IRA would include any payment or distribution (1) made on or after the date on which the individual attains age 59½, (2) made to a beneficiary (or the estate of the individual) on or after the death of the individual, (3) attributable to the individual's being disabled, or (4) which is a qualified special purpose distribution (i.e., a distribution for first-time home purchase, higher education expenses, medical expenses in excess of 7.5 percent of AGI, and long-term unemployment).

The BBA would provide that a distribution would not be treated as a qualified distribution if it is made within the 5-taxable year period beginning with the first taxable year for which the individual made a contribution to an AD IRA (or such individual's spouse made a contribution to an AD IRA). In addition, the BBA would provide that a distribution would not be treated as a qualified distribution if, in the case of a distribution attributable to a qualified rollover contribution, the distribution is made within the 5-taxable year period beginning with the taxable year in which the rollover contribution was made.

In the case of a distribution from an AD IRA that is not a qualified distribution, in applying the rules of section 72, the distribution would be treated as made from contributions to the AD IRA

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[61] The BBA also contained a provision similar to a provision enacted as part of the Small Business Act of 1996 which permits a deductible contribution of up to $2,000 for a nonworking spouse.

to the extent that such distribution, when added to all previous distributions from the AD IRA, does not exceed the aggregate amount of contributions to the AD IRA. Thus, nonqualified distributions from an AD IRA would not be included in income (and subject to the additional 10-percent tax on early withdrawals) until the AD IRA owner had withdrawn amounts in excess of all contributions to the AD IRA. In addition, the excise tax on excess distributions from qualified retirement plans (sec. 4980A) would not apply to distributions from an AD IRA.

The provision would have been effective for taxable years beginning after December 31, 1995.

Distributions from IRAs to purchase first homes, to pay higher education or financially devastating medical expenses, or to unemployed individuals (sec. 11016 of the BBA)

The BBA would have permitted withdrawals from an AD IRA or a deductible IRA to be exempt from the 10-percent tax on early withdrawals if made (1) for first-time homebuyer expenses of the individual, the individual's spouse or any child, grandchild, or ancestor of the individual or the individual's spouse, (2) for higher education expenses of the individual, the individual's spouse or any child, grandchild, or ancestor of the individual or the individual's spouse, (3) for medical expenses in excess of 7.5 percent of AGI for the individual, the individual's spouse or any child, grandchild, or ancestor of the individual or the individual's spouse, and (4) in the event of long-term unemployment for any reason. For purposes of this provision, long-term unemployment would have the same meaning as under present law (i.e., the individual has received unemployment compensation for at least 12 weeks).

The provision would have been effective for distributions after December 31, 1995.

4. IRA Provisions of the "American Family Tax Relief Act": (S.2) (Senator Roth and others) [62]

Restoration of IRA deduction for all taxpayers (sec. 401 of the bill)

The bill would increase the AGI limits applicable to deductible IRA contributions for active participants in 1997, 1998, 1999, and 2000. Thereafter, the bill would repeal the limits on IRA deductions for active participants in employer-sponsored retirement plans. Thus, under the bill, after 2000, an individual would be entitled to make a $2,000 deductible IRA contribution without regard to whether the individual was an active participant in an employer-sponsored retirement plan.

In the case of married taxpayers filing a joint return, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $65,000

[62] S. 2 was introduced on January 21, 1997, by Senators Roth, Lott, Abraham, Allard, Ashcroft, Brownback, Craig, D'Amato, DeWine, Domenici, Enzi, Faircloth, Gorton, Grams, Hagel, Hatch, Helms, Hutchison, Kyl, Murkowski, Nickles, Roberts, Santorum, Sessions, Smith (New Hampshire), Smith (Oregon), Thomas, Thurmond, Warner, Coverdell, Coats, and Kempthorne.

and $75,000; for 1998, $90,000 and $100,000; for 1999, $115,000 and $125,000; and for 2000, $140,000 and $150,000.

In the case of single taxpayers, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $50,000 and $60,000; for 1998, $75,000 and $85,000; for 1999, $100,000 and $110,000; and for 2000, $125,000 and $135,000.

The bill would provide that the IRA deduction limit for any individual is coordinated with the limit on elective deferrals under a qualified cash or deferred arrangement and under certain other plans. Thus, the sum of an individual's deductible contributions to an IRA and the individual's elective deferrals could not exceed the annual limit on elective deferrals.

The provision would be effective for taxable years beginning after December 31, 1996.

Deductible IRAs for nonworking spouses (sec. 402 of the bill)

Under the bill, an individual would not be considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is such an active participant. Thus, the bill would permit a nonworking spouse to make a deductible IRA contribution of up to $2,000 without regard to the present-law income phaseouts.

The provision would be effective for taxable years beginning after December 31, 1996.

Nondeductible contributions to tax-free IRA Plus accounts (sec. 403 of the bill)

The bill would permit taxpayers to make nondeductible contributions to new IRA Plus accounts. Generally, IRA Plus accounts would be treated in the same manner as and be subject to the same rules applicable to deductible IRAs. However, a number of special rules would apply.

Contributions to an IRA Plus would be nondeductible. The amount of nondeductible contributions to an IRA Plus that could be made for any taxable year would be tied to the limits for deductible IRAs, so that the aggregate amount of contributions to an IRA Plus could not exceed the excess of (1) the IRA deduction limit for the year (determined without regard to the rule coordinating the IRA deduction limit with the elective deferral limit) over (2) the amount of IRA contributions actually deducted for the year.

Under the bill, any qualified distribution from an IRA Plus account would not be included in gross income and would not be subject to the 10-percent additional income tax on early withdrawals. A qualified distribution from an IRA Plus account would include any payment or distribution (1) made on or after the date the IRA Plus owner attains age 59½, (2) made to a beneficiary of the IRA Plus owner after death, (3) on account of disability of the IRA Plus owner, or (4) which is a qualified special purpose distribution (i.e., a distribution for medical expenses, the costs of starting a business of the IRA Plus owner or the owner's spouse, long-term unemployment, and higher education expenses).

The bill provides that a distribution, which is made on account of attainment of age 59½, would not be treated as a qualified distribution if it is made within the 5-taxable year period beginning with the first taxable year for which the individual made a contribution to an IRA Plus account (or such individual's spouse made a contribution to an IRA Plus account). In addition, the bill provides that a distribution would not be treated as a qualified distribution if, in the case of a distribution attributable to a qualified rollover contribution, the distribution is made within the 5-taxable year period beginning with the taxable year in which the rollover contribution was made.

In the case of a distribution from an IRA Plus account that is not a qualified distribution, in applying the rules of section 72, the distribution would be treated as made from contributions to the IRA Plus account to the extent that such distribution, when added to all previous distributions from the IRA Plus account, does not exceed the aggregate amount of contributions to the IRA Plus account. Thus, nonqualified distributions from an IRA Plus account would not be included in income (and subject to the additional 10-percent tax on early withdrawals) until the IRA owner had withdrawn amounts in excess of all contributions to the IRA Plus account.

Rollover contributions would be permitted to an IRA Plus only to the extent such contributions consist of a payment or distribution from another IRA Plus or from an individual retirement plan. Such rollover contributions would not be taken into account in determining the contribution limit for a taxable year. The normal IRA rollover rules would otherwise govern the eligibility of withdrawals from IRA Plus accounts to be rolled over.

The bill would permit amounts withdrawn from IRAs to be transferred into an IRA Plus. The amount transferred would be includible in gross income in the year the withdrawal was made, except that amounts transferred to an IRA Plus before January 1, 1999, would be includible in income ratably over a 4-year period. The 10-percent early withdrawal tax would not apply to amounts transferred from an IRA to an IRA Plus account.

Under the bill, the excise tax on excess distributions from qualified retirement plans (sec. 4980A) would not apply to distributions from an IRA Plus account or to any qualified rollover contribution from an individual retirement plan to an IRA Plus account.

The provisions of the bill relating to IRA Plus accounts would be effective for taxable years beginning after December 31, 1996.

IRA withdrawals for business startup, long-term unemployment, and post-secondary education expenses (secs. 404-406 of the bill)

The bill would permit withdrawals to be made income tax free and exempt from the 10-percent additional tax if made (1) for the business start-up expenses of the individual or the spouse of the individual; (2) in the event of long-term unemployment, for any reason; or (3) for the post-secondary education expenses of the individual, the spouse of the individual, or a dependent child of the individual or the individual's spouse.

For purposes of this provision, business start-up expenses include expenses associated with the establishment of the business that are incurred on or before the business start date and on or before the date which is one year after the business start date, such as start-up expenditures within the meaning of section 195(c), organizational expenses within the meaning of sections 248(b) and 709(b), and other expenses related to starting a business (e.g., purchasing a computer, software, inventory, etc.). No deduction otherwise allowable with respect to any business start-up expense will be allowed to the extent this provision applies to such expense. In addition, to the extent this provision applies to any portion of business start-up expenses which are properly chargeable to capital account, the basis of the property to which such expenses are chargeable will be reduced by the amount taken into account under this provision.

For purposes of this provision, long-term unemployment has the same meaning as under present law (i.e., the individual has received unemployment compensation for at least 12 weeks).

For purposes of this provision, post-secondary education expenses would be defined as the student's cost of attendance as defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses).

The provision would be effective for distributions after December 31, 1996.

C. Economic Analysis of IRAs Generally

1. Comparison of Deductible IRAs, Back-End IRAs, and Nondeductible IRAs

a. General comparison of IRAs

In general

Present law and proposals to create back-end IRAs present the taxpayer with three different tax-preferred saving vehicles, each of which is called an Individual Retirement Arrangement: deductible IRAs, back-end IRAs, and nondeductible IRAs. In general, the deductible IRA and back-end IRA both offer the taxpayer a greater after-tax return than does the nondeductible IRA. The difference in return arises because the deductible and back-end IRAs effectively exempt earnings on invested funds from tax, while the nondeductible IRA taxes the earnings, but on a deferred basis.

Deductible IRAs

Deductible IRAs allow taxpayers to deduct IRA contributions from income in the year contributed, but include the entire amount in income when withdrawn. There are two potential advantages of deductible IRAs over fully taxable savings vehicles. First, taxpayers earn a tax-free rate of return on IRA investments. Second, taxpayers postpone taxation of the contribution until the contributions are withdrawn, at which time they may be taxed at a lower rate than when the contribution is made.

The following example illustrates why a deductible IRA investment receives a tax-free rate of return. Assume a taxpayer with a marginal tax rate of 28 percent contributes $1,000 to an IRA. The initial savings from the IRA is $280, the tax that would have been paid on the $1,000. For the purpose of this example, assume that the taxpayer withdraws the funds after one year without penalty.

If the annual rate of return on the IRA assets is 10 percent, the value of the IRA is $1,100, total tax due is $308, and the taxpayer is left with $792. Notice that if the taxpayer had paid the initial tax of $280 and invested the remaining $720 at 10 percent, then the taxpayer would have had $792 after one year. If the income had not been invested in an IRA, the taxpayer would have to pay tax on $72 dollars of earnings (a tax of $20.16), and would be left with $771.84 after payment of taxes. The value of the IRA is that the taxpayer does not have to pay the additional $20.16 tax. Thus, the deductible IRA allows the taxpayer to get a tax-free rate of return on an investment of $720.

This analysis is independent of the number of years the IRA investment is held. The value of the tax exemption, however, increases with the number of years the IRA is held. For instance, if in the above example, the taxpayer holds the IRA for 10 years, the IRA would be worth $1,867, whereas a fully taxed investment would be worth $1,443 after 10 years.

The deductible IRA investment can be viewed as an investment that is jointly shared by the government and the taxpayer. The government's share is equal to the tax rate (28 percent in the above example). When the IRA funds are withdrawn, the government receives its share of the funds. In the above example, when the funds are withdrawn after one year, the government receives 28 percent of $1,100 ($308), and the taxpayer receives 72 percent of $1,100 ($792). The taxpayer pays no tax on the earnings attributable to the taxpayer's share of the investment, and thus receives a tax-free rate of return on the investment. This is one advantage of investing through an IRA.

A second advantage of a deductible IRA arises if the taxpayer's marginal tax rate in the year the funds are withdrawn is lower than the marginal tax rate in the year of the contribution. Because the government's share of the investment is equal to the taxpayer's tax rate in the year the funds are withdrawn, the lower the tax rate prevailing at that time, the smaller the government's share. In the example above, for instance, if the tax rate when the funds are withdrawn is 15 percent, then the tax paid after one year would be $165. Not only does the taxpayer receive a tax-free rate of return on the taxpayer's share of the investment, but the taxpayer share of the investment is 85 percent rather than 72 percent.

Tax rates might be lower at the time the funds are withdrawn because the beneficiaries may be receiving untaxed social security benefits and reduced taxable income from other sources. However, the marginal tax rate could be lower or higher because tax rate schedules may change over time.

Back-end IRAs

From an economic perspective, back-end IRAs are similar to deductible IRAs. With a back-end IRA, the taxpayer does not deduct the IRA contribution from income, but pays no tax when the funds are withdrawn. In other words, the government takes its share before the funds are invested. The taxpayer is never taxed on the interest earned on the investment, and thus earns a tax-free rate of return on the IRA investment. This is the same tax benefit provided to deductible IRAs.

However, in the case of the back-end IRA, the tax is paid on the initial contribution at the time of contribution, and in the case of the deductible IRA, the tax is paid on the initial contribution at the time of withdrawal. In effect, the government's share of the back-end IRA is equal to the taxpayer's marginal tax rate at the time the funds are contributed, whereas the government's share of the deductible IRA is equal to the taxpayer's marginal tax rate at the time the funds are withdrawn. Whether the deductible IRA and back-end IRA are economically equivalent depends on the difference between the taxpayer's marginal tax rate in the year the contribution is made and the taxpayer's marginal tax rate in the year the IRA funds are withdrawn.

If these two marginal tax rates are equal, then the back-end IRA provides the same overall benefits as the deductible IRA. For example, if a taxpayer earns $1,000 and chooses to use it for a back-end IRA, the taxpayer first pays tax on it. If the taxpayer's marginal tax rate is 28 percent, the taxpayer will have $720 to invest. After one year earning interest at 10-percent per year, the taxpayer has $792, the same amount that the taxpayer has in the deductible IRA example above.

If the tax rate in the year the contribution is made is different from the tax rate in the year the funds are withdrawn, then the deductible IRA and the back-end IRA are no longer equivalent. When tax rates decrease over time (either because tax rates change or taxpayers fall into lower tax brackets), the deductible IRA is more advantageous, because it permits taxpayers to defer payment of tax until tax rates are lower. When tax rates increase over time, a back-end IRA is more tax-favored.

Nondeductible IRAs

Present law permits taxpayers who cannot make the maximum amount of deductible IRA contributions (because they are covered under an employer-provided pension plan and their income exceeds the dollar limits) to make nondeductible contributions to IRAs. Unlike back-end IRAs, earnings on present-law nondeductible IRA contributions are includible in income when withdrawn. The tax advantage of these IRAs is that taxes on earnings are deferred, rather than assessed annually. This permits the earnings to compound faster than with annual taxation of earnings. This advantage is the same advantage implicit in the tax treatment of the earnings on deferred annuities, which are taxed when the annuities are paid rather than when the earnings accrue.

For example, compare the accumulation of income for an investor with a 28-percent marginal tax rate on $720 which is invested for a period of 10 years at a 10-percent annual rate of return. If the earnings are taxed annually, the total available funds at the end of 10 years would be $1,443.05. The investor's annual after-tax return is 7.2 percent. If the tax is deferred for 10 years and assessed on the accumulated interest at the end of the 10-year period at a 28-percent marginal tax rate, the value of the taxpayer's investment would be $1,344.60, which represents an annual return of 7.9 percent. Unlike the deductible and back-end IRAs discussed above, the after-tax rate of return of investment in a nondeductible IRA increases as the holding period increases; as the holding period increases, accumulated earnings increase, and thus the value of deferring tax on the accumulated earnings increases.

Summary

Table 2 compares the funds available after 10 years to a taxpayer who saves $1,000 of pre-tax income in a deductible IRA, a back-end IRA, and a nondeductible IRA, assuming that no penalty tax applies and that the rate of return on the IRA assets is 10 percent per year. The tax rate in the year contributed is labeled t_o, and the tax rate in the year the funds are withdrawn is labeled t_{10}. Table 2 also summarizes the timing of the Federal Government's tax receipts.

As was noted above, the difference in the funds available to the taxpayer investing $1,000 of pre-tax income in the deductible IRA compared to the back-end IRA depends only on the difference between the marginal tax rate the taxpayer faces in the year the funds are contributed, t_o, and the marginal tax rate in the year the funds are withdrawn, t_{10}. The funds available in the nondeductible IRA are always smaller than those in the back-end IRA. Both of these IRAs tax the contribution at a tax rate t_o but the back-end IRA effectively exempts earnings from additional tax, whereas the nondeductible IRA only defers earnings from tax.

Table 2.—Funds Available to Taxpayer and Pattern of Tax Receipts Under Deductible IRA, Back-End IRA, and Nondeductible IRA

Funds Available to Taxpayer After 10 Years

Type of IRA	Funds contributed to IRA ($)	Gross funds available after 10 years ($)	Taxes due in year 10 ($)	Net funds available after tax in year 10 ($)
Deductible IRA	1,000	2,594	2,594(t_{10})	2,594 $(1-t_{10})$
Back-end IRA	1,000 $(1-t_0)$	2,594 $(1-t_0)$	0	2,594 $(1-t_0)$
Nondeductible IRA	1,000 $(1-t_0)$	2,594 $(1-t_0)$	(2,594–1,000) $(1-t_0)\,t_{10}$	2,594 $(1-t_0)$ – (1,594)$(1-t_0)\,t_{10}$

Pattern of Income Tax Payments Under Three IRAs

Type of IRA	Tax payments in—		
	Current year ($)	Year 1–9 ($)	Year 10 ($)
Deductible IRA	0	0	2,594 (t_{10})
Back-end IRA	1,000 (t_0)	0	0
Nondeductible IRA	1,000 (t_0)	0	1,594 $(1-t_0)\,t_{10}$

Assumptions:

Taxpayer has $1,000 of pre-tax income to invest in IRA, and the annual rate of return on IRA assets is 10 percent.
t_0=marginal tax rate in year of IRA contribution.
t_{10}=marginal tax rate in year of IRA withdrawal.

Table 2.—Funds Available to Taxpayer and Pattern of Tax Receipts Under Deductible IRA, Back-End IRA, and Nondeductible IRA—Continued

Example: t_0=.28, t_{10}=.28

Type of IRA	Funds contributed to IRA	Funds available after 10 years	Taxes due in year 10	Funds available after tax in year 10
Deductible IRA	$1,000	$2,594	$726	$1,868
Back-end IRA	720	1,868	0	1,868
Nondeductible IRA	720	1,868	321	1,547

Type of IRA	Tax payments in—		
	Current year	Year 1–9	Year 10
Deductible IRA	0	0	$726
Back-end IRA	$280	0	0
Nondeductible IRA	280	0	321

b. Other potential differences between deductible IRAs and back-end IRAs

The deductible and back-end IRAs may have a number of differences in addition to those due to differences in marginal tax rates. These differences involve the contribution limit, the holding period requirement, the penalty for early withdrawals, and the interaction with social security benefits.

Contribution limit

Assume the contribution limit applied to back-end IRAs is the same as that currently applicable to deductible IRAs, $2,000. Contributions to a deductible IRA are limited to $2,000 of pre-tax income, whereas contributions to a back-end IRA are limited to $2,000 of after-tax income. The $2,000 back-end IRA contribution limit effectively increases the amount of tax-free saving that can be invested in the back-end IRA relative to the deductible IRA. The following example illustrates this difference. In the case of a taxpayer with a marginal tax rate of 28 percent who contributes $2,000 to a deductible IRA earning 10 percent per year, the IRA balance will be $2,200 after one year. The taxpayer will owe $616 in tax, leaving $1,584. This is equivalent to the taxpayer having paid an initial tax of $560, or 28 percent of $2,000, and investing the remaining $1,440 at an after-tax return of 10 percent. Thus, the $2,000 limit on pre-tax income is like a limit of $1,440 on after-tax income for a taxpayer with a 28-percent marginal tax rate. If instead the investor had contributed $2,000 to a back-end IRA, the funds available to the taxpayer after one year would be the full $2,200, since no additional tax would be due.[63] The difference in the limits is only valuable to taxpayers who want to invest more than $2,000 of pre-tax income in an IRA. However, according to the IRS Taxpayer Usage Survey, in 1984, approximately 75 percent of all IRA contributors contributed the maximum permissible amount, indicating that this difference between the deductible IRA and the back-end IRA may be significant for a large number of taxpayers.

Holding period and penalties for early withdrawal

Funds in a deductible IRA that are withdrawn within five years and are withdrawn before age 59½ are subject to a 10-percent additional tax, unless certain exceptions apply. In contrast, some proposals would permit funds invested in an IRA to be withdrawn after only five years without additional tax. Thus, such proposals would provide benefits for taxpayers who plan to keep funds invested for a relatively short period of time, as well as for taxpayers who have longer investment horizons.[64]

[63] More generally, for a taxpayer facing a marginal tax rate of t, the equivalent contribution limit for a deductible IRA is C/(1-t) where C is the contribution limit for the back-end IRA.

[64] Note that for taxpayers older than age 54½, the required holding period for new contributions will actually be shorter for deductible IRAs than for proposals that require a five-year holding period (because of the age 59½ rule for deductible IRAs). Thus, older taxpayers may prefer to contribute to deductible IRAs.

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Treatment of IRA withdrawals for purposes of taxing social security benefits

Another potential difference between the deductible and the back-end IRAs is the effect of withdrawals on the taxation of social security benefits. Under present law, social security benefits are exempt from tax except for taxpayers whose income exceeds certain income thresholds. The income thresholds are defined by reference to modified adjusted gross income (AGI). Modified AGI is the taxpayer's AGI increased by the amount of interest received or accrued by the taxpayer during the taxable year that is otherwise exempt from tax. The IRS has stated that tax-exempt interest required to be included in modified AGI is the amount of interest on tax-exempt obligations received or accrued by the taxpayer during the taxable year.[65] Interest earnings that accrue on contributions to a deductible IRA are arguably not included in modified AGI because tax on such earnings is deferred, rather than exempt. However, taxable distributions from the taxpayer's IRA are part of AGI and consequently are part of modified AGI. Since distributions from a deductible IRA are taxable, but those from a back-end IRA are not, distributions from a deductible IRA are included in the taxpayer's modified AGI, but distributions from a back-end IRA are not, except perhaps to the extent that the amounts attributable to the earnings on back-end IRA contributions are deemed to be exempt interest required to be included in modified AGI.[66]

This may be an additional advantage of the back-end IRA for taxpayers who are making withdrawals from IRAs when they are also receiving social security benefits. However, it is an advantage only for taxpayers who expect their incomes to be close enough to the threshold income level that distributions from IRAs make them exceed that level.

c. Eligibility for deductible IRAs under present law

Both present law and proposals to modify IRAs limit IRAs to taxpayers with earned income. Thus, the 25 percent of tax returns that report no earned income cannot contribute to an IRA, and will not be affected by the proposals.

Table 3 focuses on taxpayers with earned income. Under present law, taxpayers who are covered by employer-sponsored pension plans and whose income exceeds certain thresholds are not eligible to make deductible IRA contributions. These restrictions prohibit 28 percent of all tax returns with earned income from claiming deductible IRA contributions, and limit eligibility for an additional 13 percent.

The percentage of taxpayers eligible to make deductible IRA contributions differs significantly by filing status and by number of earners. For instance, nearly 51 percent of joint returns with two earners, 36 percent of joint returns with one earner, and nearly 23 percent of all returns of taxpayers who are single, head of household, or married filing separately cannot claim any deductible IRA contributions. Taxpayers in the phaseout range can claim some deductible IRA contributions, but less than the maximum; 13.3 per-

[65] Rev. Rul. 84-173, 1984-2 C.B. 16.
[66] Present law is unclear on this point. See Code section 86 and its legislative history.

cent of joint returns with two earners, 11.2 percent of joint returns with one earner, and 13.3 percent of the single, head of household, and married filing separately returns fall in this category.

Table 3.—Eligibility of Taxpayers With Earned Income To Make Deductible IRA Contributions Under Present Law, Projected 1997 Returns [1]

Adjusted gross income	Returns with earned income			
	Returns (thousands)	Percent eligible for maximum deductible IRA contribution	Percent in phaseout range	Percent not eligible for any IRA deduction
Joint returns with one earner:				
Less than $10,000	1,420	100.0	0.0	0.0
$10,000 to $20,000 ...	2,327	100.0	0.0	0.0
$20,000 to $30,000 ...	2,068	100.0	0.0	0.0
$30,000 to $40,000 ...	1,965	96.9	3.1	0.0
$40,000 to $50,000 ...	1,697	0.5	99.5	0.0
$50,000 to $75,000 ...	2,922	4.3	0.0	95.7
$75,000 to $100,000	1,299	9.7	0.0	90.3
$100,000 to $200,000	1,311	13.9	0,0	86.1
$200,000 and over	590	9.7	0.0	90.3
All income classes	15,599	52.7	11.2	36.1
Average dollars eligible per return	....	[2] 2,131	[3] 217	....
Joint returns with two earners:				
Less than $10,000	1,125	100.0	0.0	0.0
$10,000 to $20,000 ...	2,277	100.0	0.0	0.0
$20,000 to $30,000 ...	2,930	100.0	0.0	0.0
$30,000 to $40,000 ...	3,564	95.4	4.6	0.0
$40,000 to $50,000 ...	3,931	1.8	98.2	0.0
$50,000 to $75,000 ...	8,509	4.0	0.0	96.0
$75,000 to $100,000	4,336	7.3	0.0	92.7
$100,000 to $200,000	2,906	10.1	0.0	89.9
$200,000 and over	559	16.6	0.0	83.4
All income classes	30,137	36.0	13.3	50.6
Average dollars eligible per return	....	[2] 3,096	[3] 225	....

Table 3.—Eligibility of Taxpayers With Earned Income To Make Deductible IRA Contributions Under Present Law, Projected 1997 Returns [1]—Continued

Adjusted gross income	Returns with earned income			
	Returns (thousands	Percent eligible for maximum deductible IRA contribution	Percent in phaseout range	Percent not eligible for any IRA deduction
Heads of households, single returns, and married filing separately: [4]				
Less than $10,000	12,312	100.0	0.0	0.0
$10,000 to $20,000 ...	15,498	99.9	0.1	0.0
$20,000 to $30,000 ...	11,294	54.5	45.5	0.0
$30,000 to $40,000 ...	6,644	0.4	99.6	0.0
$40,000 to $50,000 ...	3,725	4.2	95.8	0.0
$50,000 to $75,000 ...	3,095	5.6	0.0	94.4
$75,000 to $100,000	610	11.1	0.0	88.9
$100,000 to $200,000	462	13.4	0.0	86.6
$200,000 and over	160	13.1	0.0	86.9
All income classes	53,800	64.1	13.3	22.6
Average dollars eligible per return	....	1,944	79	....
Total, all returns	**99,536**	**53.8**	**13.0**	**28.1**
Average dollars eligible per return	....	**2,206**	**143**	....

[1] Note that the table includes imputed returns of taxpayers who do not file income tax returns, and is thus intended to be representative of the population, rather than of taxable returns. The table also includes returns filed by dependents, and may include some returns of taxpayers over age 70½ who have earned income but who are not eligible to make deductible IRA contributions.

[2] Average eligible contribution amount for taxpayers eligible to make maximum contribution.

[3] Average contribution amount for taxpayers in phaseout range.

[4] Some returns with income below $40,000 are phased out because they are returns of married individuals filing separately. IRA eligibility is phased out between $0 and $10,000 of AGI for such married individuals who live together and between $25,000 and $35,000 of AGI for such married individuals who live apart.

Source: Joint Committee on Taxation staff estimates for 1997.

These eligibility percentages and the real value of the IRA contribution limits will decrease over time, because present law does not index the contribution limits or the income eligibility limits for inflation. For example, the $40,000 AGI-limitation for joint filers to claim a fully deductible IRA contribution was established first effective for 1987 and is equivalent to an adjusted gross income today of almost $55,000 after adjusting for inflation. The real value of a $2,000 contribution has declined 43 percent since 1986 because of inflation.

Taxpayers whose eligibility is limited by the present-law rules may be likely to contribute to IRAs if eligibility were restored. As Table 5, below, demonstrates, in 1985, taxpayer returns reporting income of $50,000 or more were more than four times as likely to claim deductible contributions to an IRA as were lower-income taxpayers. After eligibility was limited in 1986, IRA contributions fell substantially. Total IRA contributions fell from a high of $38.2 billion in 1985 to $8.4 billion in 1995 (see Table 4, below). In 1996 dollars (i.e., adjusting for inflation), total IRA contributions were $55.7 billion in 1985 and $8.6 billion in 1992, representing a real decrease of 85 percent.

Under present law, for joint returns with AGI between $50,000 and $75,000, 11 percent of returns with one earner and only 8 percent of returns with two earners can claim the maximum deductible IRA contribution because neither spouse is an active participant in an employer-sponsored retirement plan. In the case of a joint return with two earners, it is possible that only one spouse is an active participant in an employer-sponsored plan. Thus, the spouse who is not an active participant is not eligible to make deductible IRA contributions because of the income reflected on the joint return. If the income phaseouts and active participant rules were applied separately to spouses filing joint returns (i.e., if all taxpayers were treated as single individuals for purposes of determining eligibility for deductible IRA contributions), then more taxpayers would be eligible to make deductible IRA contributions.

Another reason that the IRA eligibility of married couples with two earners is so low is that the income of these couples is higher generally than the income of married couples with one earner. Almost 50 percent of married couples with two earners have AGI greater than $50,000, whereas only 25 percent of couples with one earner do.

2. Present Value of Revenue Cost of IRAs to Federal Government

Assessing the cost (in the form of forgone tax receipts) to the Federal Government of IRAs may be more difficult than assessing the costs of other tax provisions, because IRAs not only change the amount of tax collected, but also change the timing of tax collections. For instance, the traditional deductible IRA can be viewed as a provision which both delays payment of tax on the contribution until withdrawal, and effectively exempts from tax any earnings on capital accumulation beyond the amount that represents interest on the delayed tax. Thus, the timing of tax payments results in a revenue loss to the government in the first years, but a revenue gain in the later years when the funds are withdrawn (see Table 2). The back-end IRA, on the other hand, loses little revenue in the beginning years, but gains no revenue in the later years because withdrawals are not taxed.

Traditional budget scorekeeping accounts for the revenue effects of proposed legislation on a cash-flow basis; in other words, the effect of a provision on budget receipts in the five or 10-year budget period is estimated without regard to whether the provision will also affect budget receipts in any year beyond the five or 10-year period. This method scores deductible IRAs as bigger revenue losers than back-end IRAs. However, a present-value calculation demonstrates that the long-term cost to the Federal Government of deductible IRAs and back-end IRAs will be approximately equal. This is because a present-value approach recognizes that tax will eventually be collected on funds in IRAs, although possibly at a lower tax rate when withdrawn.

In order to evaluate the present value of the program's cost,[67] it is also necessary to know how taxpayers would have behaved in the absence of the IRA provision. Consider first the case of a taxpayer whose tax rate in the contribution year is the same as in the year the funds are withdrawn. Then, the tax advantage of the IRA is the ability to earn a tax-free rate of return on savings. However, the cost to the government depends on what the taxpayer would have done in the absence of the program. If, in the absence of the tax benefits accorded to IRAs, the taxpayer would not have saved the money invested in the IRA, then the IRA program does not lose any government revenue in the long run. For instance, consider the example of a taxpayer who decides to invest $1,000 in an IRA. If, in the absence of the IRA, the taxpayer would have paid the $280 tax on the earnings, and spent the remaining $720, the total amount of tax collected from that $1,000 over the taxpayer's lifetime by the government would have been $280. If instead of spending the income, the taxpayer invests it in a back-end IRA, the government collects $280 from the earnings, and then never taxes the income again. Once again, the total amount collected over the taxpayer's lifetime is $280. Further, assume that the taxpayer invests in a deductible IRA for 10 years in a fund that earns 8 percent per year. In the first year, the government loses $280 in revenue, since the taxpayer deducts the $1,000 from income. In year 10, the $1,000 has grown to $2,158.93, and the taxpayer owes $604.50. Since $604.50 is exactly equal to $280 plus 10 years of interest at 8 percent per year, the government receives the $280 with interest, and collects the same amount of revenue that it would have had there been no IRA program. In present value terms, the taxpayer pays $280 over his or her lifetime. To the extent that deductible IRAs permit taxpayers to pay tax on their funds at a lower marginal rate than when the contribution was made, the government does lose revenue even if the funds invested in the IRA represent funds which would otherwise have been consumed (i.e., new saving.)

On the other hand, if the contribution to the IRA represents income that would have been invested for the same 10 years in an interest-bearing account (i.e., old saving), the IRA reduces revenues to the government. If the earnings in the above example would have instead been invested in a fully taxable asset earning 8 percent per year, the government would have collected the $280 tax on the initial earnings, plus an additional $136 in present value (using a discount rate of 8 percent) of taxes on the annual interest

[67] To calculate the present value of the cost to the government of IRAs, it is necessary to use the government's discount rate. If repayment of taxes is uncertain, then the discount rate used should be higher than the government's borrowing rate.

earnings. Thus, the cost of the IRA program in this case for this particular taxpayer would be $136.

The above examples represent the polar cases of the present value of the revenue effect for IRA contributions—contributions that represent only new savings and contributions that represent savings that would otherwise have been invested in a fully taxable asset.[68] Other possibilities can also be considered. For instance, saving for an IRA may be diverted from other tax-favored assets, in which case the tax loss is not as great. For example, under the bills, if taxpayers who contribute to a deductible IRA would have invested in a nondeductible IRA under present law, then the tax loss consists of the difference between the tax advantage of the deductible IRAs and the tax advantage of the nondeductible IRAs. Similarly, investment in housing is currently tax favored. If taxpayers divert income that would have been invested in housing to IRAs, the present value of the revenue cost to the Federal Government may be relatively small.

Finally, giving taxpayers the choice between the deductible and the back-end IRA is likely to increase the present value of the revenue cost of the IRA program relative to a program offering either IRA alone. Taxpayers who have reason to believe that their tax rates will decline over time should be more likely to choose the deductible IRA, and taxpayers who believe their tax rates will increase over time should choose the back-end IRA.

If IRAs do not generate new saving, then IRAs reduce the present value of revenues of the Federal Government. If the Federal Government responds to these reduced revenues by reducing expenditures or increasing other taxes, then IRAs that do not increase personal saving will have no effect on national saving.[69] If, on the other hand, the Federal Government offsets the reduced revenues by borrowing, then IRAs will actually reduce the national saving rate.

3. The Effectiveness of IRAs at Increasing Saving

a. Theoretical effects

In general

IRAs have a number of attributes that may affect a taxpayer's saving decision. First, investments in IRAs earn a higher after-tax rate of return than investments in other assets. Second, IRAs may provide an incentive for retirement saving, as opposed to other forms of saving. Third, deductible IRAs may provide a psychological incentive to save. Fourth, advertising by banks and other financial institutions of IRAs may influence people's saving decisions. The following discussion focuses on each of these attributes.

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[68] Actually, the revenue loss can be even greater than the case presented. If IRAs reduce saving, then not only does the government lose the tax revenue that would have been collected on the IRA investment, but it also loses the tax revenue on the saving that was not undertaken because of the IRA. The possibility that IRAs reduce private saving is discussed below.

[69] This assumes that neither reduced expenditures nor increases in other taxes affect personal saving.

Rate of return

In general

Both the deductible IRA and the back-end IRA effectively exempt the return on savings from tax, thereby increasing the rate of return to saving. When the return on saving increases, the price of future consumption decreases, because the taxpayer has to forgo fewer dollars today to consume a dollar's worth of consumption in the future.

This price decrease can affect saving in two ways. Since future consumption is now cheaper, taxpayers may choose to substitute future consumption for current consumption. This effect increases saving. When the price of future consumption falls, though, the amount of investment necessary to achieve any particular level of income in the future decreases. For example, a taxpayer in the 28-percent marginal tax bracket may set aside $1,300 today to help defray tuition expenses of his child 15 years from now. If the taxpayer's investment earns 8 percent annually and those earnings are taxed annually at a 28-percent tax rate, in 15 years the investment will be worth $3,000. If the taxpayer instead invested in a back-end IRA, an investment of only $946 today would be worth $3,000 in 15 years (assuming the same 8-percent return). This effect decreases saving because the tax benefit permits the taxpayer to save less to accumulate the same amount of money in the future.

Substantial disagreement exists among economists as to the effect on saving of increases in the net return to saving. Some studies have argued that one should expect substantial increases in saving from increases in the net return.[70] Other studies have argued that large behavioral responses to changes in the after-tax rate of return need not occur.[71] Empirical investigation of the responsiveness of personal saving to after-tax returns provides no conclusive results. Some find personal saving responds strongly to increases in the net return,[72] while others find little or a negative response.[73]

Even if increasing the rate of return on all saving does increase saving generally, it is still possible that increasing the rate of return on IRAs would not affect saving. For increased rates of return to influence taxpayers to substitute future consumption for current consumption, the marginal rate of return on savings must increase so that if the taxpayer increases saving, that saving receives a higher rate of return. In order for IRAs to increase the marginal return to saving, taxpayers must not be able to finance the IRA profitably by borrowing, must not have other similar assets that can be easily shifted into an IRA, and must intend to save less than the maximum contribution allowed. The following discussion provides examples of how each of these situations may affect the impact of IRAs on saving.

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[70] See, Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, 71, September 1981.

[71] See, David A. Starrett, "Effects of Taxes on Saving," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman (eds.), *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington: Brookings Institution), 1988.

[72] See, Michael Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, 86, April 1978.

[73] See, George von Furstenberg, "Saving," in Henry Aaron and Joseph Pechman (eds.), *How Taxes Affect Economic Behavior* (Washington: Brookings Institution), 1981.

Borrowing

When interest on borrowed funds is deductible, it may be profitable for a taxpayer to borrow to contribute to an IRA. For example, consider a taxpayer with a 28-percent marginal tax rate without any assets. If the taxpayer can borrow at an interest rate equal to the rate of return on an IRA investment, then one would not expect the taxpayer to increase the amount of income saved. Instead, the borrower can borrow $2,000, invest in the IRA and deduct the interest cost. Since the IRA earnings are effectively exempt from tax, the taxpayer receives the full value of the IRA benefit, but does not increase saving.[74] Given that the taxpayer can receive the IRA benefit without increasing saving, the decision of whether to save an extra dollar is unaffected, because that extra dollar will not receive a higher after-tax return than it would have without the availability of tax benefits for IRAs.

If the taxpayer must pay a higher interest rate on the loan than can be received on the investment, the benefits to borrowing to finance an IRA are reduced, but not eliminated. For example, if investments in IRAs earn 10 percent per year and the taxpayer's marginal tax rate is 28 percent, the taxpayer could profitably borrow to fund the account even if the annual interest rate on the loan was as high as 13.8 percent. However, in this case, the taxpayer would gain little from borrowing, and might choose to finance the IRAs with increased savings instead.

Present law permits taxpayers to deduct investment interest but not most personal interest. It is unclear whether interest on a loan used to finance a deductible IRA would be considered investment interest or personal interest. It is likely, however, that interest on a loan used to finance a back-end IRA would not be deductible, whether or not secured by the taxpayer's home, because it would be viewed as interest on amounts used to finance tax-exempt interest and subject to section 265. Furthermore, present law does not allow IRA assets to be used as security for a loan. Because interest paid on home-equity loans generally is deductible, the easiest way to borrow to finance IRAs may be through home-equity loans. Borrowing against home equity to finance IRAs is similar to shifting existing assets into IRAs.

Shifting of existing assets

Taxpayers who have existing assets that exceed the IRA contribution limits can also receive the benefit of IRAs without increasing saving. Consider a taxpayer who saves only $400 annually, but has been saving for years, and has $4,500 in financial assets. The first year the taxpayer has the opportunity to invest in an IRA, the taxpayer can shift $2,000 from the financial assets to the IRA. The second year, the taxpayer can once again shift $2,000 into the IRA. Only in the third year will the tax benefits accorded to IRAs increase the rate of return on new saving.

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[74] However, if the taxpayer begins repaying the loan before the IRA funds are withdrawn, even this loan-financed IRA investment might be associated with increased saving. This possibility is discussed in greater detail below.

Shifting of planned assets

Finally, taxpayers who would have saved without the IRA may not increase their saving due to the availability of IRAs. For example, consider a taxpayer who habitually saves $4,000 per year. If this taxpayer is provided the opportunity to invest in an IRA, then $2,000 of these savings will be diverted to the IRA. However, the IRA does not provide a marginal incentive to save. If the taxpayer saves $4,001, the return on that extra dollar of saving will be no higher than it would have been without the IRA program. The taxpayer may even decrease the amount saved, since the first $2,000 of saving that is in the IRA will provide more income in the future, and hence the need for saving may decrease.

Type of saving

The above discussion focused on saving in general. Many authors have noted that certain IRAs may provide incentives for retirement saving, as opposed to saving for other purposes.[75] For instance, consider the effect of the deductible IRA, which is subject to additional tax unless held until retirement or used for other qualified purposes. An individual who is saving only for a "rainy day" may not have much saving that is expected to last until retirement. When offered a higher rate of return on retirement saving, that individual may choose to increase the total amount of saving by maintaining the rainy day saving and adding retirement saving.

Similarly, an individual who takes out a home equity loan to finance an IRA may not save any additional money in the year the IRA contribution is made. But if that individual slowly repays that loan, and this repayment represents saving the taxpayer would not otherwise have done, then the IRA increased that individual's saving.

To the extent the provisions for penalty-free early withdrawal of the IRA and the reduced holding period requirements of the proposals to modify IRAs increase the substitutability of IRA saving for other saving, this retirement saving attribute of IRAs is diminished, making substitution of current savings for IRA savings more likely.

Psychological impact of IRAs and effects of increased advertising

Some observers have noted that IRAs may have a larger impact on saving than standard economic analyses would predict.[76] These observers suggest that the immediate reward of the tax deduction and the active marketing campaigns in the mid-1980s contributed to the high IRA participation rates observed; in fact, IRA participation was larger than was expected. The sharp decline in advertising after 1986 may explain the decline in IRA contributions among taxpayers who are still eligible.

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[75] See the discussion in William G. Gale and John Karl Scholz, "IRAs and Household Saving," *American Economic Review*, 84, December 1994, and Steven F. Venti and David A. Wise, "Tax Deferred Accounts, Constrained Choice, and Estimation of Individual Saving," *Review of Economic Studies*, 53, August 1996.

[76] See, Richard H. Thaler, "Psychology and Savings Policies," *American Economic Review*, 84, May 1984.

Furthermore, there may also be a psychological factor that contributes to the impact of IRAs on saving. One study found that taxpayers who owed money to the IRS in excess of taxes withheld were significantly more likely to make IRA contributions than were other taxpayers.[77] One might expect this psychological factor only to induce deductible IRA contributions, which will have an immediate effect on taxes paid. However, another author[78] noted that taxpayers who owe the IRS money generally have higher incomes and this may be why they are more likely to contribute to IRAs, rather than any psychological factor.

b. Empirical research on the effect of IRAs on saving

Deductible IRAs have been very popular with taxpayers. As Table 4 reports, contributions to IRAs increased significantly when eligibility restrictions were eliminated in 1982. At the peak in 1985, over $38 billion was contributed to IRAs. This represented almost 20 percent of personal saving for that year.

Table 4.—IRA Participation, 1979–1995

Year	Returns claiming IRA deduction (millions)	Percentage of all returns (percent)	Deductions claimed ($ billions)
1979	2.5	2.6	3.2
1980	2.6	2.7	3.4
1981	3.4	3.6	4.8
1982	12.0	12.6	28.3
1983	13.6	14.1	32.1
1984	15.2	15.3	35.4
1985	16.2	15.9	38.2
1986	15.5	15.1	37.8
1987	7.3	6.8	14.1
1988	6.4	5.8	11.9
1989	5.8	5.2	10.8
1990	5.2	4.6	9.9
1991	4.7	4.1	9.0
1992	4.5	3.9	8.7
1993	4.4	3.8	8.5
1994	4.3	3.7	8.4
1995[1]	4.3	3.7	8.4

[1] Preliminary data.

Source: Internal Revenue Service, *Statistics of Income*, various years.

However, it is unclear whether IRAs actually increased total saving. There is no consensus within the economics profession on the effect of the pre-1986 IRAs on personal saving. Some economists believe that IRAs had no effect on overall personal saving; some believe that IRAs increased personal saving; and some economists be-

[77] Feenberg, Daniel, and Jonathan Skinner, "Sources of IRA Saving," in Lawrence Summers (ed), *Tax Policy and the Economy*, vol. 3 (Cambridge: Massachusetts Institute of Technology Press), 1989.

[78] Gravelle, Jane, "Do Individual Retirement Accounts Increase Savings?", *Journal of Economic Perspectives*, 5, Spring 1991.

lieve that IRAs would have eventually increased saving if the universally available deductible IRA had been maintained.

A number of economists argue that most of the IRA contributions consisted of taxpayers shifting into IRAs from existing assets.[79] They point to the fact that IRA contributions were concentrated at the top of the income distribution, and that IRA contributors had large stocks of financial assets compared to noncontributors with the same income. Both of these facts suggest that IRA contributors had assets and desired saving above the contribution limit. Others note that IRAs are only one component of an individual's wealth and substitution of IRA assets for other financial assets is not the only possible response. Most IRA contributors held substantial housing equity and IRA contributions could substitute for increasing the equity in one's home.[80]

Economists who believe that IRAs did not increase saving point to the fact that personal savings in the United States was not higher during the years that deductible IRAs were available to all taxpayers.[81] Some also find the magnitude of IRA contributions as implausibly large in comparison to total personal saving to have represented substantial new saving. For example, personal saving in 1985 was $189.3 billion (see Table 8), and IRA contributions were $38 billion, or almost one fifth of all personal saving.

A number of economists argue that IRA contributions between 1982 and 1986 consisted largely of new saving.[82] These proponents also observe that the empirical evidence in favor of the thesis that IRAs increase national saving can be replicated on several different sources of data.[83] Some of these economists have investigated whether IRA contributors shifted existing assets from taxable accounts into IRAs. If such shifting had occurred, they argue, one would expect to find a reduction in taxable asset earnings following the IRA contribution. However, one study found that taxpayers who contributed to IRAs generally were also increasing their investment in taxable assets.[84] Although this does not prove that the money invested in IRAs would not have been saved otherwise, it may provide evidence against the simple existing asset shifting view.

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[79] See, for example, Galper, Harvey and Charles Byce, "Individual Retirement Accounts: Facts and Issue," *Tax Notes*, vol. 31, June 2, 1986, pp. 917-921.

[80] See, Eric M. Engen, William G. Gale, and John Kohl Scholz, "The Illusory Effects of Saving Incentives on Saving," *Journal of Economic Perspectives*, 10 Fall 1996. These authors are generally skeptical of the econometric evidence offered in support of the thesis that IRAs increase saving.

[81] See Gravelle, Jane "Do Individual Retirement Accounts Increase Savings?".

[82] See, Venti, Steven F. and David A. Wise, "The Evidence on IRAs," *Tax Notes*, vol. 38, January 25, 1988, pp. 411-416. Venti and Wise have authored several studies that use different data to analyze IRAs and household saving. They generally conclude that IRAs increase household saving. The aforementioned article summarizes these studies. Some analysts have criticized the methodology of studies which claim IRAs create new saving and argue that the reported results of the effect of IRAs on saving are implausibly large. See Gravelle, Jane G., "Capital Gains Taxes, IRA's, and Savings," CRS Report for Congress 89-543, September 26, 1989. A recent critique is provided by Gale, William G. and John Karl Scholz, "IRAs and Household Saving," *American Economic Review*, 84, December 1994.

[83] See, James M. Poterba, Stevin F. Venti, and David A. Wise, "How Retirement Saving Programs Increase Saving," *Journal of Economic Perspectives*, 10, Fall 1996. This study reviews the evidence in favor of the thesis that IRAs increase national saving and offers criticism of the results and methodology of those studies that find little saving effect.

[84] See, for example, Feenberg, Daniel, and Jonathan Skinner, "Sources of IRA Saving." Also, Venti, Steven F. and David A. Wise, "Government Policy and Personal Retirement Saving," in James Poterba (ed.), *Tax Policy and the Economy*, vol. 6, (Cambridge; Massachusetts Institute of Technology Press), 1992.

Further, proponents of IRAs note that to the extent that taxpayers do shift existing assets into IRAs, most taxpayers do not have enough financial assets to continue asset shifting indefinitely. Hence, they conclude, IRAs would eventually provide a marginal incentive to save.[85]

Some economists have noted that the introduction in Canada of savings incentives similar to the IRA was followed by large increases in Canadian saving. They argue that this can be taken as evidence that IRAs are effective in increasing national saving.[86] However, others note that since Canadians are not able to deduct home mortgage interest from taxable income, they should be less likely to finance tax-favored savings with home borrowing, and therefore savings incentives in Canada may be more likely to induce increased saving than in the United States.

Even if some portion of the monies contributed in IRAs represents new saving, net national saving need not increase. Increases in saving by an individual household do not create increases in saving by the nation, if the saving was financed by a reduction in tax revenues which necessitates government borrowing. Some analysts have attempted to measure the amount of new household saving that would be necessary for the net increase in private capital accumulation to exceed the present value of the tax revenue loss to the government over the life of an IRA account. As discussed in Part III.C.2., above, IRAs lose tax revenue by the first year deduction and because taxes are postponed on funds that would otherwise have been saved in taxable accounts. Upon withdrawal, IRAs generate tax revenue. Such a benefit/cost calculation is sensitive to assumptions about interest rates, tax rates and the length of time for which the IRA is held. One study estimated that if none of each dollar contributed in an IRA were new saving by the household, net private capital would increase by 22 cents for each dollar of government revenue loss.[87] That is, the government spends one dollar in forgone tax revenue to produce 22 cents worth of private capital formation. The study estimates that if 10 cents of each dollar contributed to an IRA were new household saving, their net private capital would increase by 81 cents for each dollar of government revenue loss. However, the study estimates that if 19 cents of each dollar contributed to an IRA were new household saving, then net private capital would increase by $1.51 for each dollar of government revenue loss.[88] Such a calculation suggests that modest contributions of new household saving to IRAs may lead to increases in the capital stock in excess of the government revenue loss incurred. However, as the study's authors caution,

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[85] See Skinner, Jonathan, "Do IRAs Promote Saving? A Review of the Evidence," *Tax Notes*, vol. 54, January 13, 1992, pp. 201-202.

[86] See, Carroll, Chris, and Lawrence H. Summers, "Why Have Private Saving Rates in the U.S and Canada Diverged?" *Journal of Monetary Economics*, 20, September 1987.

[87] Private capital increase even if the monies contributed to an IRA are not new household saving because the household implicitly invests the value of the IRA tax-deductible contribution.

[88] See, R. Glenn Hubbard and Jonathan S. Skinner, "Assessing the Effectiveness of Saving Incentives," *Journal of Economic Perspectives*, 10, Fall 1996. This analysis assumes assets are held in the IRA for 22 years, contributions were made when the taxpayer was in a 36-percent tax bracket, withdrawals were made when the taxpayer was in a 28-percent tax bracket, that 29 percent of the portfolio was invested in equities earning 9.35 percent annually, and the remainder was invested in bonds earning 4.0 percent annually. The discount rate on government debt was assumed to be 5.55 percent.

such calculations are sensitive to the selection of tax rate and investment earnings parameters.

c. Distributional effects of IRAs under present and prior law

Tables 5 and 6 summarize information on IRA participation in 1985 and 1995. In 1985, 71 percent of all returns reporting IRA contributions had AGI below $50,000, and 29 percent had AGI of $50,000 or above. However, taxpayers with AGI of $50,000 or above represented only 8 percent of all returns eligible for IRAs. Thus, although many lower-income individuals contributed to IRAs, most did not, whereas most taxpayers with AGI of $50,000 or above did contribute when eligible. Taxpayers with AGI of $50,000 or above were more than four times as likely to contribute to an IRA than were taxpayers with AGI below $50,000—61.8 percent of eligible returns with AGI of $50,000 or above reported contributions to an IRA, while only 13.8 percent of eligible returns with AGI below $50,000 reported IRA contributions.

Higher income taxpayers made larger contributions as well. Taxpayers with adjusted gross incomes of $50,000 or more constituted approximately 29 percent of all IRA contributors in 1985, but accounted for more than 35 percent of IRA contributions. In 1995, taxpayers with adjusted gross incomes of $50,000 or more constituted approximately 21 percent of all IRA contributors, but accounted for approximately 32 percent of IRA contributions.

Because the value of the IRA is the effective exemption of the earnings from tax, the higher a taxpayer's marginal tax rate, the more valuable the ability to invest through an IRA. Because people in higher income classes generally have higher tax rates, the value of their IRA is larger than the value of IRAs for taxpayers in lower income classes. However, the value of the IRA depends on tax rates throughout the period the IRA is held, and not just the marginal tax rate in the year the contribution is made.

Table 5.—IRA Participation By Income Class, 1985

Adjusted gross income class	Returns reporting IRA contributions		
	Number in millions	Percent of eligible returns [1]	Contributions ($ billions)
All classes	16.2	17.8	38.2
Under $10,000	0.6	2.3	1.1
$10,000 to $30,000	5.1	13.6	9.7
$30,000 to $50,000	5.7	32.9	13.5
$50,000 to $75,000	3.0	56.5	8.7
$75,000 to $100,000	0.9	74.1	2.7
Over $100,000	0.8	76.1	2.6

Source: Internal Revenue Service, *1985 Statistics of Income.*

[1] Eligible taxpayers include self-employed persons as well as wage and salary employees. However, taxpayers whose income consists solely of interest income, for example, were ineligible to contribute to IRAs.

Table 6.—IRA Participation By Income Class, 1995

Adjusted gross income class	Returns reporting IRA contributions		
	Number in millions	Percent of returns with wage and salary income[1]	Contributions ($ billions)
All classes	4.3	4.3	8.4
Under $10,000	0.3	1.1	0.5
$10,000 to $30,000	1.6	4.5	2.8
$30,000 to $50,000	1.4	7.2	2.4
$50,000 to $75,000	0.4	3.6	1.1
$75,000 to $100,000	0.2	4.7	0.6
Over $100,000	0.3	6.7	1.0

[1] Includes self-employed persons reporting wage income as well as wage and salary employees. However, because the income limitations enacted by the Tax Reform Act of 1986, not all such taxpayers are eligible to make deductible contributions to IRAs.

Source: Internal Revenue Service, *1995 Statistics of Income* (Preliminary).

Other authors have noted that even the taxpayers with low income who did contribute to IRAs owned more financial assets than other low-income taxpayers and that, therefore, IRA contributors may not be representative of taxpayers in general. Table 7 presents information on the assets of households with IRAs compared to the assets of households without IRAs. Part of the reason that IRA contributors have larger holdings of assets than noncontributors is that contributors to IRAs tend to be older than noncontributors, and older taxpayers have been accumulating assets longer.

Table 7.—Estimated Median Financial Assets of Households with IRAs and Households Without IRAs, 1985

Income	Households with IRAs	Households without IRAs
Less than $10,000	$7,625	$0
$10,000 to $20,000	6,538	200
$20,000 to $30,000	6,365	900
$30,000 to $40,000	6,015	1,692
$40,000 to $50,000	10,000	2,694
$50,000 to $75,000	14,516	5,100
$75,000 and over	36,085	9,735

Source: Steven Venti and David Wise, "The Saving Effect of Tax-Deferred Retirement Accounts: Evidence from SIPP," in B. Douglas Bernheim and John Shoven (eds.) *National Saving and Economic Performance* (Chicago: University of Chicago Press), 1991, p. 110.

d. Expected differences between effects of pre-1986 IRAs and proposed modifications

Although research on the effectiveness of the pre-1986 IRA provisions can shed light on the potential of IRAs to affect savings, several differences between the pre-1986 experience and today should be noted. First, marginal tax rates for most taxpayers are lower now than they were before the passage of the Tax Reform Act of 1986. The tax advantage of IRAs is the exemption from tax of the investment's return and, for the deductible IRA, the possibility that the rate at which the contribution is taxed will be lower when the contribution is withdrawn. Both of these advantages may be less valuable now than they were before 1987, especially for higher income taxpayers because their marginal tax rates decreased the most. For example, if prior to 1987, a taxpayer in the 50-percent marginal tax bracket received a 10-percent return on his or her investment, excluding such income from tax would increase his or her net return to 10 percent from an after-tax return of 5 percent. At the present, such a taxpayer would be in the 39.6-percent marginal tax bracket and the exemption would increase his or her net return to 10 percent from an after-tax return of 6.04 percent. Thus, the exemption provided a greater increase in net return prior to 1987. Similarly, if taxpayers believe that tax rates are likely to increase over time because of the Federal Government's budget deficit, or because current tax rates are relatively low from a historical perspective, then the deductible IRA will look less attractive than it appeared in the past.

Second, some proposals to modify IRAs would create IRAs that are different from the pre-1986 IRAs, both because they provide additional exceptions to the early withdrawal penalty, or by requiring a relatively short required holding period. These differences may alter the effectiveness of IRAs at increasing saving. To the extent that taxpayers already save for education, housing, and medical expenses, allowing IRAs to be used for these purposes increases the likelihood that existing assets or existing planned saving will be shifted into IRAs, reducing the effectiveness of IRAs at increasing savings. Similarly, to the extent that taxpayers already save for short-term goals and for "rainy days," reducing required holding periods may also encourage more asset shifting. Further, permitting short holding periods and penalty-free early withdrawal may cause taxpayers to keep their money in the IRAs a shorter period of time.[89] On the other hand, to the extent that taxpayers who would otherwise choose to save in the form of IRAs would not do so because they believe they might need the funds before retirement, this added flexibility may encourage more taxpayers to invest in IRAs and increase their saving rate. Finally, permitting penalty-free withdrawals before retirement age diminishes the effectiveness of IRAs as explicit retirement savings vehicles, but may not change the overall effectiveness of IRAs to increase saving.

The ability of individuals to save through employer-sponsored retirement plans, particularly qualified cash or deferred arrangements (sec. 401(k) plans) may affect the level of IRA contributions.

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[89] Although once funds are withdrawn from an IRA, they can only be replaced at a rate no faster than the annual contribution limit per year.

While such plans existed prior to 1986, they have become more prevalent since then. Section 401(k) plans offer benefits similar to those of IRAs. However, individuals may contribute more to such plans on a pre-tax basis ($9,500 for 1997), and may obtain increased benefits if, as is often the case, the employer matches employee contributions. Despite these advantages, some may still view an IRA as attractive, for example, because IRA funds may be withdrawn at any time (subject to the early withdrawal tax), whereas the ability to obtain withdrawals from section 401(k) plans prior to termination of employment is more limited. On the other hand, many section 401(k) plans permit individuals to borrow from their account, making investments in such plans more liquid.

The ability to contribute both to a section 401(k) (or similar) plan and an IRA could affect IRA contributions in a number of ways. For example, some individuals would save only through a section 401(k) plan, others would chose the IRA, and still others would split savings between a section 401(k) plan and an IRA. A number of factors may affect such choices, including the amount the individual wishes to save, the period and purpose for which they wish to save, and the particular terms of the section 401(k) plan they are eligible to participate in.

D. Issues Relating to Tax Incentives For Saving And IRAs

1. Comparison of IRAs With Other Tax-Favored Assets

Present law contains various tax incentives for savings. Tax incentives are provided to encourage taxpayers to save for certain purposes and to encourage taxpayers to save in certain forms. Saving for the purpose of education and retirement is subsidized through the tax treatment of certain Treasury bonds and of certain retirement plans. Incentives are also provided for people to save in the form of investments in housing, life insurance, and municipal bonds.

Tax-favored treatment of assets does not always increase the rate of return on saving. If the supply of a tax-favored asset is limited relative to the demand for that asset, much of the benefit of the tax treatment will be realized by the initial owners of the asset, rather than by the subsequent holders of the asset. For instance, holders of municipal bonds may not receive a higher after-tax rate of return than holders of taxable bonds because, even though the earnings are tax exempt, municipal bonds offer lower rates of return. The issuers of municipal bonds receive a tax benefit because they can pay lower interest rates than the rates paid on other securities.

The tax benefits of IRAs and pension funds, however, are not limited to particular assets. Because investors in IRAs and pension funds can invest in a wide range of assets, and because the amount of funds permitted to be invested through these tax-favored vehicles is limited (the demand is small relative to the supply of assets), investors in IRAs and pension funds do receive a higher rate of return than that available through other investments, and thus do benefit from the tax-favored treatment.

Enactment of additional saving incentives would be expected to alter taxpayers' choices among various taxable and tax-preferred assets. Because the income earned on assets held in IRAs effectively is exempt from tax, the taxpayer maximizes the benefit of the tax preference by directing the investment of IRA contributions in assets which are not otherwise tax preferred. The benefits of tax preferences for assets that are tax preferred to one degree or another are maximized when such assets are held outside an IRA.

The expansion of IRAs could be expected to increase the demand for otherwise taxable instruments at the expense of instruments which are tax preferred under present law. On the other hand, the annual contribution limitation of the IRA would limit the effect on the demand for other tax-preferred instruments. Moreover, to the extent that savings incentives generate increases in saving, the demand for all instruments would increase. If this were to occur, the issuers of instruments which are tax-preferred under present law conceivably could benefit as the cost of capital declined.

2. Goals of Tax Incentives for Saving

Some argue that tax incentives for saving are appropriate because the income tax system taxes the return to income that is saved, thereby lowering the return to saving. This lower return on saving affects both the national saving rate, as well as the assets that taxpayers accumulate for particular purposes. There is some disagreement about whether the goal of tax incentives for saving should be to encourage saving for particular purposes or to increase national saving.[90] These purposes are not mutually exclusive; if effective, incentives to save for particular purposes will increase national saving. However, general saving incentives will not necessarily fulfill more specific goals. Whether new tax incentives for saving should be aimed at increasing national saving in general, or increasing retirement saving, depends on the perceived adequacy of each type of saving.

In particular, IRAs have historically been viewed as vehicles for retirement savings. When IRAs were introduced in 1974, they were provided only to individuals without employer-provided pension plans. The original intention of the IRA was explicitly to encourage individuals not participating in an employer-sponsored plan to increase their retirement savings and to provide a higher return on such savings. Even with the liberalization of eligibility requirements for IRAs in the Economic Recovery Tax Act of 1981, IRAs still have been largely devoted to retirement saving. Withdrawals of IRA funds before age 59½ generally are still subject to an additional 10-percent tax.

However, IRAs can provide substantial benefits to taxpayers who are saving for nonretirement purposes. For example, consider a taxpayer with a 28-percent marginal tax rate who has $1,000 of earnings to devote to saving. Without an IRA, the taxpayer would pay a tax of $280, leaving $720 to be invested. If this amount earns 8 percent annually and the earnings are taxed annually at a 28-percent marginal tax rate, the taxpayer will have $1,261 at the end of 10 years. If, however, the taxpayer can deduct the $1,000 and accumulate 8-percent annual interest tax free, the investment will

[90] Part III.D.3, below, discusses the importance of national saving. Part III.D.4, below, discusses the adequacy of retirement saving.

be worth $2,159 at the end of 10 years. After including the distribution in income, subject to the additional 10-percent tax on early withdrawals, the taxpayer will have $1,339, or $78 more than the taxpayer has if a taxable investment is made.

Similarly, the present-law exceptions to the early withdrawal tax may permit taxpayers to use deductible IRAs for nonretirement saving. Under present law, a taxpayer may make penalty-free withdrawals from an IRA prior to attaining the age of 59½ if the distributions are made over certain periods. For example, a taxpayer could purchase an annuity which promises level payments for the remainder of the taxpayer's life. This exception may offer many taxpayers a way to receive a substantial percentage of the tax-favored funds prior to age 59½ and avoid the 10-percent penalty. At age 50, the average American male has a life expectancy of approximately 26 years.[91] At a 10-percent discount rate, an annuity which pays $1,000 per year for 26 years has a present value of approximately $9,160. The present value of the payments received during the first 10 years of such annuity is approximately $6,145, or 67 percent of the total value of the annuity. Consequently, if the taxpayer withdrew the $9,160 from his IRA to purchase the $1,000 annuity, he would receive 67 percent of the total value of the annuity prior to age 60.[92]

3. Role of Saving in the National Economy

Investment and economic growth

When an economy's rate of investment increases, the economy's stock of capital increases. A larger, capital stock permits greater production of goods and services. Because the larger a country's capital stock, the more productive its workers, investment also leads to higher wages and salaries. Thus, increases in investment lead to future increases in a nation's standard of living.

It is important to distinguish gross investment from net investment. Gross investment includes investment in new capital as well as investment that is undertaken to replace depreciated or worn out capital. Net investment measures increases to the capital stock. (Net investment is equal to gross investment less depreciation).

In the short run, increases in gross investment will increase the capital stock. As the capital stock increases, worker productivity increases and the economy will experience a higher rate of growth. In the long run, any given rate of investment will just be sufficient to replace the existing, though larger, capital stock as it depreciates. Thus, in the long run, an increase in the level of investment increases a nation's standard of living, but may not increase a country's long run rate of growth.

It is possible that a higher investment level can lead to a higher growth rate even in the long run. Even if there is no growth in net investment, investment to replace depreciated capital may still en-

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[91] Bureau of the Census, U.S. Department of Commerce, *Statistical Abstract of the United States, 1990*, p. 73.

[92] If an 8-percent discount rate were used, the percentage recovered in the first 10 years would be approximately 62 percent.

If such an annuity were purchased by a 40-year old male (life expectancy an additional 35 years), he would receive approximately 64 percent of the present value of the annuity (discounting at 10 percent) in the first 10 years and 88 percent by age 60.

hance economic growth to the extent that the replacement capital embodies improved (and more efficient) equipment and technologies. The higher the gross investment rate, the more new capital is purchased each year, and thus the rate at which new technologies get adopted may be higher.

Sources of investment funds

Investment involves a trade-off between consumption today and consumption tomorrow. Investment can either be financed by national saving, or by foreign borrowing (saving by foreigners). A basic accounting identity of the national income and product accounts states that:[93]

Investment = Private Saving + Government Saving + Net Foreign Borrowing

Many analysts in the past ignored the foreign sector, primarily because at the time it was small relative to the U.S. economy. These analysts interpreted this basic relationship as saying that national investment must equal national saving, where national saving is the sum of private saving and public saving.

However, national investment need not equal national saving if foreigners can invest in the United States. The experience of the 1980s, when investment in the United States greatly exceeded national savings, demonstrates how important this source of funds can be. When demand for investment funds in the United States outstrips the supply of national savings, interest rates rise in response. Increases in interest rates attract foreign capital to the United States, and the excess of investment over national saving is financed by foreigners' saving.

Foreign investment in the United States also is related to the value of the dollar and the trade deficit. To take advantage of high interest rates in the United States, foreign investors first must con-

[93] The national income and product accounts measure the flow of goods and services (product) and income in the economy. Two common measures of the size of the economy are the gross domestic product (GDP) and the gross national product (GNP). GDP measures the total value of the output of the American economy. GNP measures the total annual value of goods and services produced by Americans, their gross income. GDP is greater than GNP by the payment of factor income to the rest of the world (such as profits to foreign owners of U.S. based businesses), but is less than GNP by the amount of factor income received from the rest of world by Americans (such as wages paid to Americans who work abroad). Examining the income measure, GNP, is useful in understanding the trade-off between consumption tomorrow. GNP may be measured in several ways. One way is to measure GNP by expenditure on final product in the economy. By this measure,

(1) GNP = C + I + G + (X-M).

Equation (1) is an accounting identity which states that gross national product equals the sum of consumption expenditures (C), investment expenditures on plant, equipment, inventory, and residential construction (I), governmental purchases of goods and services (G), and net exports (exports less imports of goods and services or X-M).

An alternative is to measure GNP by the manner in which income created in the economy is disposed of. By this measure,

(2) GNP = C + S + T.

Equation (2) is another accounting identity which states that gross national product equals the sum of consumption expenditures, saving by consumers and businesses (S), and net tax payments to the government (T) (net tax payments are total tax receipts less domestic transfer, interest, and subsidy payments made by all levels of government).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity,

(3) I = S + (T-G) + (M-X)

This is the basis for the statement that national investment equals private saving (S), plus public saving (T-G), and net imports (M-X).

vert their currencies to dollars. This increases demand for the dollar, thereby increasing the dollar's exchange rate relative to the foreign currency. A stronger dollar makes imported goods relatively cheaper and our exports relatively more expensive. As a consequence, net exports fall and the trade deficit increases. A further accounting identity states that: [94]

Net Foreign Borrowing = (Imports-Exports)

When net foreign borrowing increases, the trade deficit (the difference between imports and exports of goods and services) also increases. Thus, many people have blamed the trade deficits of the 1980s on the low national savings rate during that period.[95]

Is the United States' saving rate too low?

Consequences of a low saving rate

The consequences of a low saving rate depend on the mobility of international capital. If capital is not mobile, then, as discussed above, investment is equal to national savings. When the saving rate is low, so is the investment rate. Historically, there has been a strong relationship between a country's rate of investment and its rate of saving.[96] Although this relationship has become weaker over time,[97] it is still true that countries with high saving rates also generally have high investment rates.

If capital is mobile (that is, if foreigners can invest in the United States at low cost and without a lot of added risk), then investment will not decline as much when the saving rate falls. Instead, investment will be financed by foreigners, either by direct foreign investment in the United States or by foreign lending to American investors. When domestic saving rates are low, foreign financing of domestic investment results in a higher rate of investment than would be possible if investment were financed by domestic saving. Foreign investment in the United States does increase the productivity of American workers. However, the profits generated by foreign investment flow abroad, since the United States has to pay interest on the funds it borrows. Furthermore, eventually the debt will have to be repaid, so the net wealth that is left to future generations of Americans is smaller than it would be if the investment were financed by domestic saving.

Trends in national saving and investment

National saving is generally divided into private saving and public saving. Private saving is comprised of household or personal saving and business saving. Households save by not spending all of their disposable income (i.e., after-tax income). Businesses save

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94 This ignores the relatively small amount of unilateral transfers to foreigners. For a more detailed discussion of foreign trade and domestic saving and investment, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

95 For instance, see Hatsopoulos, Krugman, and Summers, "U.S. Competitiveness: Beyond the Trade Deficit," *Science*, 15 July 1988, vol. 241, pp. 299-307.

96 See, for instance, Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows," *Economic Journal*, vol. 90 (June 1980) pp. 314-29.

97 See Phillippe Bacchetta and Martin Feldstein, "National Saving and International Investment", in Douglas Bernheim ad John Shoven (eds.), *National Saving and Economic Performance* (Chicago: The University of Chicago Press), 1991.

by retaining some of their earnings. Public saving reflects the extent to which the Federal, State, and local governments run budget surpluses or deficits. Table 8 presents data on the components of net national saving in the United States.

Table 8.—Components of Net National Saving, Selected Years, 1929–1992

[In billions of dollars]

Year	Private saving			Public saving			Total net national saving
	Net personal saving	Net business saving	Total net private saving	Federal surplus or deficit (−)	State and local surplus or deficit (−)	Total public saving	
1929	2.6	2.4	5.0	1.2	−0.2	1.0	6.0
1939	1.8	0.3	2.1	−2.2	0.0	−2.2	−0.1
1949	7.4	10.5	17.9	−2.6	−.7	−3.4	14.5
1954	16.4	9.8	26.2	−6.0	−1.1	−7.1	19.1
1959	22.0	15.9	37.9	−2.6	−0.5	−3.1	34.8
1964	31.6	26.1	57.7	−2.6	1.0	−1.6	56.1
1969	43.3	24.7	68.0	8.5	1.5	10.0	78.0
1974	93.4	22.4	115.8	−11.6	7.1	−4.5	111.3
1975	100.3	40.8	141.1	−69.4	4.6	−64.8	76.3
1976	93.0	47.2	140.2	−52.9	14.6	−38.3	101.9
1977	87.9	61.9	149.8	−42.4	25.6	−16.8	133.0
1978	107.8	70.2	178.0	−28.1	31.1	2.9	180.9
1979	123.3	62.1	185.4	−15.7	25.1	9.4	194.8
1980	153.8	33.8	187.6	−60.1	24.8	−35.3	152.3
1981	191.8	31.7	223.5	−58.8	28.5	−30.3	193.2
1982	199.5	18.4	217.9	−135.5	26.9	−108.6	109.3
1983	168.7	54.3	223.0	−180.1	40.3	−139.8	83.2
1984	222.0	87.5	309.5	−166.9	58.1	−108.8	200.7
1985	189.3	91.9	281.2	−181.4	56.1	−125.3	155.9
1986	187.5	55.3	242.8	−201.0	54.3	−146.8	96.0
1987	142.0	86.5	228.5	−151.8	40.1	−111.7	116.8

Table 8.—Components of Net National Saving, Selected Years, 1929–1992—Continued

[In billions of dollars]

Year	Private saving			Public saving			Total net national saving
	Net personal saving	Net business saving	Total net private saving	Federal surplus or deficit (−)	State and local surplus or deficit (−)	Total public saving	
1988	155.7	112.6	268.3	−136.6	38.4	−98.3	170.0
1989	152.1	86.9	239.0	−122.3	44.8	−77.5	161.5
1990	170.0	88.5	258.5	−163.5	25.1	−138.4	123.1
1991	201.5	102.3	303.8	−203.4	7.3	−196.2	107.6
1992	238.7	90.4	329.1	−276.3	7.2	−269.1	60.1

Source: Department of Commerce, Bureau of Economic Analysis.

Table 9 presents net saving by component as a percentage of gross domestic product (GDP). As the table demonstrates, net business saving,[98] net private saving, and public saving were all lower during the 1980s then in any of the three previous decades. Net national saving declined through most of the 1980s.

Some analysts suggest that because households save out of their disposable income (i.e., after-tax income), it is more appropriate to examine personal saving relative to disposable income than to examine personal saving relative to GDP. Table 10 presents personal saving as a percentage of disposable income. Generally, the same trends observed in Table 9 are evident in Table 10.

[98] Tables 8 and 9 present net saving, which equals gross saving less capital consumption (depreciation).

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Table 9.—Components of Net National Savings as a Percentage of GDP, Selected Years, 1959–1995

Year	Net personal saving	Net business saving	Total net private saving	Public saving	Total national saving
1959	4.79	4.79	7.53	2.41	9.94
1960	4.42	2.41	6.84	3.29	10.12
1961	5.19	2.39	7.58	2.44	10.02
1962	5.04	3.20	8.24	2.48	10.71
1963	4.63	3.43	8.07	2.98	11.05
1964	5.35	3.67	9.02	2.35	11.37
1965	5.26	4.16	9.41	2.57	11.99
1966	4.96	4.02	8.99	2.53	11.51
1967	5.87	3.47	9.33	1.08	10.41
1968	5.14	2.89	8.03	1.89	9.92
1969	4.77	2.30	7.08	3.03	10.11
1970	5.89	1.71	7.60	0.65	8.25
1971	6.10	2.46	8.56	−0.32	8.24
1972	5.14	2.76	7.90	0.95	8.85
1973	6.48	2.72	9.20	1.61	10.81
1974	6.52	1.44	7.96	0.91	8.86
1975	6.40	2.46	8.86	−2.84	6.02
1976	5.30	2.58	7.88	−1.17	6.71
1977	4.56	2.63	7.20	−0.08	7.12
1978	4.91	2.71	7.62	0.91	8.53
1979	5.09	2.09	7.18	1.33	8.50
1980	5.81	0.83	6.64	−0.24	6.40
1981	6.39	1.07	7.46	−0.08	7.38
1982	6.34	0.81	7.15	−2.57	4.58
1983	4.75	1.55	6.30	−3.12	3.18
1984	6.04	2.33	8.37	−1.77	6.60
1985	4.93	2.22	7.15	−1.72	5.43
1986	4.44	1.23	5.67	−1.87	3.80
1987	3.59	1.61	5.20	−0.96	4.24
1988	3.74	2.05	5.79	−0.70	5.09
1989	3.45	1.40	4.85	−0.34	4.52
1990	3.63	1.34	4.98	−1.30	3.68
1991	4.16	2.13	6.29	−2.03	4.26
1992	4.37	1.17	5.54	−3.12	2.42
1993	3.27	1.65	4.92	−2.45	2.47
1994	2.73	2.00	4.73	−1.30	3.42
1995	3.44	1.98	5.41	−0.92	4.49
Average 60–69	5.06	3.19	8.26	2.46	10.72
Average 70–79	5.64	2.36	8.00	0.19	8.19
Average 80–89	4.95	1.51	6.46	−1.34	5.12
Average 90–95	3.60	1.71	5.31	−1.85	3.46

Source: Department of Commerce, Bureau of Economic Analysis.

Table 10.—Personal Saving as a Percentage of Disposable Personal Income, Selected Years, 1929–1996

Year	Personal saving as a percentage of disposable personal income
1929	3.2
1939	2.6
1944	25.1
1949	3.9
1954	6.3
1959	7.0
1964	7.7
1969	7.0
1974	9.3
1975	9.0
1976	7.6
1977	6.6
1978	7.1
1979	7.4
1980	8.2
1981	9.1
1982	8.8
1983	6.6
1984	8.4
1985	6.9
1986	6.2
1987	5.0
1988	5.2
1989	4.8
1990	5.0
1991	5.7
1992	5.9
1993	4.5
1994	3.8
1995	4.7
1996 [1]	4.8

[1] Arithmetic average of first three quarters.

Source: Department of Commerce, Bureau of Economic Analysis.

Prior to 1980, domestic saving generally financed domestic investment as well as providing funds for Americans to be net investors abroad (negative net foreign investment). During the 1980s, net savings fell short of domestic investment as a share of GDP. Domestic investment declined from its 1984 peak and net foreign investment provided for the difference in domestic savings and investment. Thus, although the decline in saving was coincident with a decline in investment, this decline was not as severe as it might have been had there not been foreign investment.

Comparison between the saving rates of the U.S. and other countries

The United States' national saving rate is low when compared to that of other nations. Table 9 showed that the United State's net national saving averaged approximately 5 percent of GDP in the 1980s. The net national saving rate of Canada during the 1980s averaged 7.3 percent of GDP. For Japan the comparable rate was 17.9 percent; Germany, 9.2 percent; Italy, 8.3 percent; France, 6.7 percent; the United Kingdom, 4.5 percent; and Australia, 3.4 percent.[99] Table 11 presents a comparison for household or personal saving. As Table 11 indicates, the household saving rate of the United States during the 1980s was below the household saving rates of Canada, Germany, and Japan.[100]

[99] Organization for Economic Co-Operation and Development, *National Accounts, 1960-1989*, vol. 1, 1991.

[100] The data on international saving rates in the text and in Table 11 are not directly comparable to the data in Tables 9 and 10 because such data are not always compiled consistently across nations. For example, in computing household saving rates, the OECD subtracts household interest expense from income to determine U.S. household disposable income. The Bureau of Economic Analysis does not make a similar adjustment in defining household disposable income. Also, while the source of the international comparisons draws on data from the OECD, which attempts to provide data on an internationally comparable basis, the data are not fully comparable. For example, in computing household saving rates, the definition of the household sector is not identical across all countries. In particular, except in Japan, France, and Italy, private nonprofit institutions are included in the household sector. See, Andrew Dean, Martine Durand, John Fallon, and Peter Hoeller, "Saving Trends and Behaviour in OECD Countries," OECD, Economics and Statistics Department Working Paper, No. 67, June 1989.

Table 11.—Net Household Saving as a Percentage of Disposable Household Income, Selected Years, 1972–1995

Country	1972	1976	1980	1984	1988	1990	1991	1992	1993	1994	1995	Average 1986–1995
United States	7.5	7.6	8.4	8.6	5.3	5.2	5.8	5.7	4.7	4.2	4.9	5.2
Japan	18.2	23.2	17.9	15.8	13.0	12.1	13.2	13.1	13.4	12.8	13.0	13.2
Germany	14.4	13.3	12.8	11.4	12.8	13.8	12.9	12.9	12.2	11.7	11.6	12.5
Canada	8.7	11.8	13.6	15.0	9.7	9.7	9.9	10.3	9.6	7.6	7.0	9.4
Australia	11.8	11.1	10.8	9.9	6.1	6.9	5.2	4.6	3.3	3.2	2.6	5.1

Source: Organization for Economic Co-Operation and Development, *OECD Economic Outlook,* 60, December 1996.

Generally, saving rates of all nations have declined from the rates of the late 1960s. In percentage terms, the decline in the national saving rate of the United States between 1967 and 1989 update is greater than the decline of the saving rates of Japan and Germany, but comparable to the decline of the saving rates of France and Italy.

Although many people have pointed to the low saving rate in the United States as a cause of declining productivity, others argue that the United States has long been a relatively low-saving nation, and yet has enjoyed substantial economic growth. They note that many of the nations with higher saving rates were nations which needed to rebuild after the destruction of war on their own territory.

Furthermore, some argue that the low saving rate in the United States may be a product of demographics, and that the saving rate will increase as the baby boomers enter their forties and fifties, typically the years during which people do much of their retirement saving. However, others note that in the past, demographic changes have not been very successful at predicting saving rates.

In general, the decline in private saving rates is not well understood. It is likely that demographic changes, capital market liberalization, increased insurance availability, and increased social security benefits have all contributed to the decline. However, these factors have not proved significant enough to account for the total decline in the saving rate. Similarly, there is no convincing explanation for why saving rates have declined in other nations as well.

4. The Adequacy of Retirement Savings

a. Economic status of the elderly

Sources of retirement income

Social security is the largest source of retirement income (40 percent in 1992), followed by income from assets (21 percent in 1992), earnings (17 percent in 1992), and private and government employee pensions (19 percent in 1992).[101] Many researchers have attempted to measure whether people have adequate savings for retirement. A common measure of retirement savings adequacy is called the replacement rate, which is defined as the ratio of retirement income over income during the working years.

The issue of what replacement rate should be called adequate depends on a number of factors. A replacement rate of 100 percent means that the person's income during retirement is equal to their income during working years. There are a number of reasons that a replacement rate of 100 percent may not be optimal. First, people may desire to have more income during the working years because some of that income is saved for retirement. If people choose to have constant consumption over time, they save during their working years and dissave during retirement. Second, most elderly own their own homes (in 1994, more than 80 percent of those households headed by an individual aged 65 to 74 and 73.5 percent of

[101] Social Security Administration as reported in Joint Committee on Taxation, *Selected Materials Relating to the Federal Income Tax System Under Present Law and Various Alternative Tax Systems* (JCS-1-96), March 14, 1996, p.41.

households headed by an individual age 75 or over[102]) and most of these (83 percent in 1987[103]) have paid off their mortgages. Thus, most elderly receive housing without incurring any expenses beyond maintenance and utilities, whereas during their working years, they were likely to have been making mortgage payments. Third, few elderly households care for children, and therefore household expenses are likely to be lower. Fourth, the elderly are generally covered by Medicare, which provides insurance against large medical expenses and pays for most expenditures on health. Fifth, social security benefits, which represent the major source of retirement income, are largely untaxed.[104] Thus, social security benefits can be smaller than income earned during the working years and still provide the same after-tax income. For the lowest income groups, this effect is not large since earned income is subject to the payroll tax, but probably not subject to the income tax.

These arguments suggest that the appropriate replacement rate for the elderly to have adequate retirement savings is less than 100 percent. However, there may be some factors which dictate that the replacement rate should be higher than 100 percent. First, although the elderly are covered by Medicare, they are also more likely to incur large medical expenses which may not be completely covered by Medicare. Similarly, Medicare generally does not cover nursing home care or the costs of care in other long-term care facilities, and only those elderly poor enough to receive Medicaid or eligible through veterans' assistance are covered.

Replacement rates for social security and pension income for retired workers are calculated using two methods. The first method calculates the ratio of social security and pension benefits relative to a worker's highest career earnings.[105] The second method calculates benefits relative to the average earnings in the five years preceding retirement.[106] It seems likely that the career high earnings overstate average earnings, and earnings during the five years preceding retirement understate average earnings. Thus, these two replacement rates may be seen as upper and lower bounds of estimates of the replacement of average career earnings. These replacement rates measure the replacement of income through retirement benefits, and do not include any income earned during retirement or any income from savings. Such calculations indicate that social security and pension benefits replace roughly 33 percent of the career high earnings and 50 percent of earnings over the last five years for individuals. When spousal benefits are taken into account, replacement rates are slightly higher, averaging 30 to 33 percent of highest earnings but 60 to 70 percent of last earnings. Such calculations also demonstrate that replacement rates are highest for the poor. For the lowest income quartile, individual re-

[102] *Statistical Abstract of The United States 1995*, Table 1288 page 736.
[103] *Statistical Abstract of The United States 1990*, Table 1278, page 722.
[104] Social security benefit recipients with modified AGI exceeding certain limits have to include up to 50 percent of their benefits in income. The Joint Committee on Taxation staff projects that in 1997, 23 percent of all elderly included some portion of social security benefits in taxable income.
[105] Earnings are indexed by the rate of wage growth. Highest career earnings are defined as the average of the highest five years of earnings.
[106] This measure is calculated only for those individuals who worked a significant amount during the five years preceding retirement.

placement rates varied between 34 and 39 percent of highest earnings, and 72 to 94 percent of last earnings.[107]

Finally, social security benefits have increased over time. Social security benefits relative to the income of the elderly have increased substantially over the past 40 years.

Poverty

Another method used to examine the economic status of the elderly is to compare their rates of poverty to those of the general population. Poverty among the elderly has declined dramatically over the last 30 years, from over 35 percent in 1959 to 12 percent in 1988. By 1988, the poverty rate of the elderly was less than the poverty rate of the general population. The poverty rate of elderly persons living in families (with a spouse or children) was 6.2 percent, lower than for any other group. The major explanation for this decline in poverty is the increase in social security benefits and coverage described above.

b. Expected retirement income and needs of current workers

The above discussion demonstrates that, as a group, the elderly are as well off as the rest of society, indicating that given social security and pension benefits, savings were adequate. However, to determine whether the savings of current workers are enough to provide adequate retirement income, it is necessary to examine how this group might differ from current retirees.

Social security and employer-provided pension plan coverage

Because social security coverage of workers has increased over time,[108] and because the labor force participation of women has also been increasing, current workers are more likely to be covered by social security than current retirees. Similarly, pension coverage of current workers is also substantially larger than of current retirees.[109]

Personal saving

Although coverage by pensions and social security is expected to be higher for current workers than it is for current retirees, the saving rate of current workers may be lower than the rate at which current retirees saved during their working lives. This would imply that although one source of retirement income, retirement benefits, is expected to be higher for current workers, another source, income from savings, may be lower.

The measure of personal saving used in the National Income and Product Accounts attributes all corporate pension contributions and earnings to the household sector. Thus, the increased pension coverage is already included in the measure of household saving. Table 9, above, shows that personal saving has been declining over the past 15 years. Private saving, which includes the saving of business, and which may provide a better measure of total house-

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[107] Susan Grad, "Earnings Replacement Rates of New Retired Workers," *Social Security Bulletin 53, October 1990.*

[108] For a discussion of the legislative history of social security coverage, see Committee on Ways and Means, *Overview of Entitlement Programs* (WMCP 102-9), May 7, 1991, pp. 105-106.

[109] *EBRI Databook on Employer Benefits*, 1990, p. 75.

holds saving since businesses are ultimately owned by households, exhibits the same downward trend. Thus, the saving of the current generation of workers for their retirement seems to be low relative to the past.

In a recent study, the Congressional Budget Office ("CBO") reported that while the saving rate of current workers appears low relative to the past, this may not imply that the level of savings is inadequate for retirement. That CBO study concludes that the so-called "baby boom" generation appears to be accumulating assets at a rate equivalent to that of their parents who are currently retired. The CBO concludes that the continued increase in real wages, the fact that baby boomers are more highly educated than their parents, and the increased participation of women in the labor force portend "increases in household incomes of baby boomers in retirement."[110] Some have criticized the conclusion of this study as too optimistic. Critiques note that finding that baby boomers have accumulated approximately the same amount of assets as had their parents at a similar age does not bode well for retirement income. Having the same amount of assets would imply only the potential for the same amount of income as experienced by current retirees, and as incomes grow this would imply future retirees would be less well off compared to the rest of society than are current retirees. Critics also note that current retirees benefited from increases in social security benefits and unexpected capital gains on housing that the baby boomers may not reasonably expect to experience.[111]

c. Increased retirement costs

Finally, it is possible that the need for retirement income is increasing over time. Increases in life expectancies and trends toward earlier retirement increase the number of years in retirement and therefore, increase the need for saving. Furthermore, the normal retirement age for social security was changed in 1983. In 1995, the normal retirement for social security (the age at which retirees receive full benefits) is 65. By 2010, normal retirement will be 67 years. If the increase in the normal retirement age means that individuals will be working more years, then current saving need not adjust. However, if the historical trend toward earlier retirement continues, then the increase in normal retirement age for receipt of full social security benefits means that individuals should increase their retirement saving.

Similarly, increased life expectancies and rapid medical cost inflation increase the probability of large medical expenses. Out-of-pocket medical expenditures for the elderly have been steadily increasing over the last 15 years. Also, many people have noted that the probability of an individual requiring long-term care some time in their lifetime has been increasing. Provisions contained in the Health Insurance Portability and Accountability Act that provided

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[110] Congressional Budget Office, "Baby Boomers in Retirement: An Early Perspective," September 1993, p. xiv. Also see, Joyce Manchester, "Baby Boomers in Retirement: An Early Perspective," in Dallas Salisbury and Nora Super Jones (eds.), *Retirement in the 21st Century: Ready or Not?* (Washington: Employee Benefits Research Institute), 1994.

[111] B. Douglas Bernheim, "Adequacy of Savings for Retirement and the Role of Economic Literacy," in Dallas Salibury and Nora Super Jones (eds.), *Retirement in the 21st Century: Ready or Not?* (Washington: Employee Benefits Research Institute), 1994.

favorable tax treatment for long-term care insurance and expenses and provided for penalty-free withdrawals from IRAs for certain medical expenses and insurance of individuals and their spouses and dependents may aid individuals in providing for their retirement years. The proposals may also assist in providing for medical expenses by further expanding penalty-free IRA withdrawals to medical expenses of relatives, whether or not they are dependents.

IV. ESTATE AND GIFT TAXATION

A. Present Law

Application of the estate and gift tax

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.[112] Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers [113] and reach 55 percent on cumulative taxable transfers over $3 million (sec. 2001(c)). In addition, a 5-percent surtax is imposed upon cumulative taxable transfers between $10 million and $21,040,000, to phase out the benefits of the graduated rates and the unified credit (sec. 2001(c)(2)).[114]

The amount of gift tax payable for any calendar year generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period.

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer during his lifetime or at death and then subtracting any gift taxes payable for prior calendar years (after 1976). This amount is reduced by any available unified credit (and other applicable credits) to determine the estate tax liability.

A marital deduction generally is permitted for the value of property transferred between spouses.

Unified credit

A unified credit is available with respect to taxable transfers by gift and at death. Since 1987, the unified credit amount has been $192,800 (sec. 2010), which effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax.

The unified credit originally was enacted in the Tax Reform Act of 1976. As enacted, the credit was phased in over five years to a level that effectively exempted $175,625 of taxable transfers from the estate and gift tax in 1981 (i.e., a unified credit of $47,000).

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[112] Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

[113] Due to the operation of the unified credit, the first $600,000 in cumulative taxable transfers is effectively exempt from estate and gift tax. For transfers in excess of $600,000, estate and gift tax rates begin at 37 percent.

[114] Thus, if a taxpayer has made cumulative taxable transfers exceeding $21,040,000, his or her average transfer tax rate is 55 percent.

The Economic Recovery Tax Act of 1981 increased the amount of the unified credit each year between 1982 and 1987, from an effective exemption of $225,000 in 1982 to an effective exemption of $600,000 in 1987. The unified credit has not been increased since 1987.

Annual exclusion for gifts

A taxpayer may exclude $10,000 of gifts made to any one donee during a calendar year (sec. 2503). This annual exclusion does not apply to gifts of future interests (e.g., reversions or remainders). Prior to 1982, the annual exclusion was $3,000.

Valuation

Generally, for Federal transfer tax purposes, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Fair market value is determined as of either (1) the time of the decedent's death, or (2) the "alternate" valuation date of six months after the decedent's death (sec. 2032).

Under Code section 2032A, an executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value. Currently, the maximum reduction in the value of such real property resulting from an election under Code section 2032A is $750,000.

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at the time of death; (2) the value of the farm or closely held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property) is at least 50 percent of the decedent's gross estate (reduced by mortgages and other secured debts); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;[115] (4) the real property qualifying for current use valuation must pass to a qualified heir;[116] (5) such real property must have been owned by the decedent or a member of the decedent's family and used or held for use as a farm or closely held business ("a qualified use") for 5 of the last 8 years prior to the decedent's death; and (6) there must have been material participation in the operation of the farm or closely held business by the decedent or a member of the decedent's family in 5 years out of the 8 years immediately preceding the decedent's death (Code sec. 2032A (a) and (b)).[117]

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[115] For purposes of the 50-percent and 25-percent tests, the value of the property is determined without regard to its current use value.

[116] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants.

[117] In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for current use valuation includes the farmhouse, or other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

If, after an election is made to specially value property at its current use value, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special use valuation. Some courts have held that the cash rental of specially valued property after the death of the decedent is not a qualified use and, therefore, results in the imposition of the additional estate tax under section 2032A(c). *Martin v. Commissioner*, 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party); *Williamson v. Commissioner*, 93 T.C. 242 (1989) (cash lease to family member).

Contributions for conservation purposes

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (secs. 2055(f), 2522(d)). Qualifying conservation purposes are: (1) the preservation of land areas for outdoor recreation by, or the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit, and is either for the scenic enjoyment of the general public, or pursuant to a clearly delineated governmental conservation policy; or (4) the preservation of an historically important land area or certified historic structure (sec. 170(h)(4)). For this purpose, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property (sec. 170(h)). Also, a contribution will be treated as "exclusively for conservation purposes" only if the conservation purpose is protected in perpetuity.

Generation-skipping transfer tax

A generation-skipping transfer tax ("GST tax") generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations and taxable distributions.[118] The generation-skipping transfer tax is imposed at a flat rate of 55 percent on cumulative generation-skipping transfers in excess of $1 million. Because both the generation-skipping transfer tax and the estate or gift tax can apply to the same transfer, the combined marginal tax rate on a generation-skipping transfer can be as high as 80 percent.

Under the "predeceased parent exception", a direct skip transfer to a transferor's grandchild is not subject to the GST tax if the child of the transferor who was the grandchild's parent is deceased

[118] For this purpose, a direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person (e.g., a gift from grandparent to grandchild). A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or a direct skip).

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at the time of the transfer (sec. 2612(c)(2)). This "predeceased parent exception" to the GST tax is not applicable to (1) transfers to collateral heirs, e.g., grandnieces or grandnephews, or (2) taxable terminations or taxable distributions.

Installment payment of estate tax

In general, the estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate pays only interest for the first four years, followed by up to 10 annual installments of principal and interest. Interest is generally imposed at the rate applicable to underpayments of tax under section 6621 (i.e., the Federal short-term rate plus 3 percentage points). Under section 6601(j), however, a special 4-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business. All interest paid on the deferred estate tax is allowed as a deduction against either the estate tax or the estate's income tax obligation. If the deduction is taken against the estate tax, supplemental returns must be filed each year to recompute the value of the taxable estate.

To qualify for the installment payment election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate. An interest in a closely held business includes: (1) any interest as a proprietor in a business carried on as a proprietorship; (2) any interest in a partnership carrying on a trade or business if the partnership has 15 or fewer partners, or if at least 20 percent of the partnership's assets are included in determining the decedent's gross estate; or (3) stock in a corporation if the corporation has 15 or fewer shareholders, or if at least 20 percent of the value of the voting stock is included in determining the decedent's gross estate. In general, the installment payment election is available only if the estate directly owns an interest in a closely held active trade or business. Under a special rule, however, an executor may elect to look through certain non-publicly traded holding companies that own stock in a closely held active trade or business, but if the election is made, neither the five-year deferral (i.e., the provision that requires no principal payments until the fifth year) nor the special 4-percent rate applies.

If the installment payment election is made, a special estate tax lien applies to any property on which tax is deferred for the installment payment period.

B. Legislative Background

Federal death taxes before World War I

While States extensively used death taxes,[119] Federal death taxes in this country, for most of its history, were imposed pri-

[119] The term "death taxes" is used to refer to taxes that are imposed at the time of the death of an individual. As used herein, the term includes taxes with other names. Such taxes include "inheritance taxes" and "estate taxes." An "inheritance tax" is a tax on the right to receive property at death from an individual and generally is measured by the amount that a particular legatee receives from the decedent. An "estate tax" is a tax on the right to transfer property

marily to finance wars or threat of war. The first Federal death tax was imposed from 1797 until 1802 as a stamp tax on inventories of deceased persons, receipts of legacies, shares of personal estate, probates of wills, and letters of administration to pay for the development of strong naval forces felt necessary because of strained trade relations with France.[120] Subsequent to the repeal of the stamp tax,[121] there were no death taxes imposed by the Federal Government until the Civil War when the Federal Government imposed an inheritance tax between 1862 and 1870.[122] In order to finance the Spanish-American War, the Federal Government imposed its first estate tax in 1898 which remained in effect until its repeal in 1902.[123] While prior death taxes were primarily imposed to finance warfare, President Theodore Roosevelt proposed, in 1906, a progressive tax on all lifetime gifts and death time bequests to limit the amount that one individual could transfer to another although no legislation immediately resulted from such proposal.[124]

Estate taxes from World War I through World War II

Estate taxes to finance World War I

The commencement of World War I caused revenues from tariffs to fall. The Federal Government in 1916[125] adopted a progressive estate tax on all property owned by the decedent at his or her death, certain lifetime transfers which were for inadequate consideration,[126] transfers not intended to take effect until death,[127] and transfers made in contemplation of death.

The 1916 estate tax provided an exemption (in the form of a deduction) of $50,000 with rates from 1 percent on the first $50,000 of transferred assets to 10 percent on transferred assets in excess of $5 million. The next year, the revenue needs from the War caused increases in estate tax rates with a top rate of 25 percent on transfers in excess of $10 million.[128]

Estate and gift taxes between World Wars I and II

In the Revenue Act of 1918, estate tax rates on transfers under $1 million were reduced, but the tax was extended to life insurance proceeds in excess of $40,000 that were receivable by the estate or its executor and property subject to a general power of appointment.[129]

In 1924, the estate tax was changed by: (1) increasing the maximum rate to 40 percent; (2) broadening property subject to the tax to include jointly owned property and property subject to a power retained by the decedent to alter, amend, or revoke the beneficial

at death and generally is measured by the total amount passing at the time of the decedent's death. Historically, inheritance taxes were imposed by States, while estate taxes were imposed by the Federal Government.

[120] Act of July 6, 1797, 1 Stat. 527.
[121] Act of June 30, 1802, 2 Stat. 148.
[122] Act of July 1, 1862, 12 Stat. 432, 483; Act of July 15, 1870, 16 Stat. 256.
[123] War Revenue Act of 1898, 30 Stat. 448, 464 (July 4, 1898).
[124] See quotation in Paul, Randolph E., Taxation in the United States, p. 88 (Boston, 1954).
[125] Act of September 8, 1916, 39 Stat. 756.
[126] This rule is contained in section 2043 of present law.
[127] This rule is contained in section 2037 of present law.
[128] Act of March 3, 1917, 39 Stat. 1000.
[129] This rule is now contained in sections 2041 and 2514 of present law.

enjoyment of the property;[130] and (3) allowing a credit for State death taxes for up to 25 percent of the Federal tax. In addition, the first gift tax was imposed.

In 1926, the gift tax was repealed and estate tax rates were reduced to a maximum rate of 20 percent on transfers over $10 million. The exemption was increased from $50,000 to $100,000, and the credit for State death taxes was increased to 80 percent of the Federal tax.[131]

In 1932, with the advent of the Depression which reduced revenues from other sources and the need for revenues for new Government projects, estate tax rates were increased with a top rate of 45 percent on transfers over $10 million.[132] The tax was made applicable to lifetime transfers in which the transferor retained a life estate or the power to control who shall benefit from the property or income therefrom.[133] The exemption was reduced to $50,000, and the Federal gift tax was reimposed (at 75 percent of the estate tax rates) for cumulative lifetime gifts in excess of $5,000 per year.

Estate and gift tax rates were increased in 1934 to top rates of 60 percent and 45 percent, respectively, on transfers in excess of $10 million and again in 1935 to top rates of 70 percent and 52.5 percent, respectively, on transfers in excess of $50 million.[134] The exemption for both the estate and gift tax was reduced in 1935 to $40,000 each.[135]

In 1940, a 10-percent surcharge was imposed on both income and estate and gift taxes, in light of the need for additional revenue necessitated by the military build-up just prior to World War II.[136] Estate and gift tax rates were increased in 1941, with a top estate tax rate of 77 percent on transfers in excess of $50 million.[137]

Estate and gift taxes during World War II

In 1942, Congress again altered estate and gift taxes by: (1) setting the exemption from the estate tax at $60,000, the lifetime exemption from the gift tax at $30,000, and providing an annual gift tax exclusion of $3,000;[138] and (2) attempting to equate property in community property States with property owned in non-community property States by providing that in both community property States and non-community States, each spouse would be taxed on the portion of jointly owned or community property that each spouse contributed to that property's acquisition cost.[139]

130 This rule is now contained in section 2038 of present law.

131 This rule is now contained in section 2011 of present law. The size of the credit has not changed even though the Federal estate tax rates subsequently have been changed several times.

132 Revenue Act of 1932, 47 Stat. 169 (June 6, 1932).

133 This rule is now contained in section 2036(a) of present law.

134 Act of May 10, 1934, 48 Stat. 680.

135 Act of August 30, 1935, 49 Stat. 1014.

136 Revenue Act of 1940, 54 Stat. 516.

137 Act of September 20, 1941, 55 Stat. 687.

138 The $60,000 deathtime and the $30,000 lifetime exemptions remained at these levels until the Tax Reform Act of 1976 when the estate and gift taxes where combined into a single unified tax that could be reduced by a unified credit which replaces the two exemptions.

139 Act of October 21, 1942, 56 Stat. 798.

Estate and gift taxes after World War II

Post-World War II through 1975

The 1942 solution to the community property problem was viewed as complex. Congress provided a different solution in 1948 for equating community property States and non-community property States by providing the decedent or donor spouse a marital deduction for 50 percent of the property transferred to the other spouse and, thus, effectively allowing both spouses to be taxed on one-half of the property's value.[140]

In 1954, the estate tax treatment of life insurance was changed to a rule that subjected life insurance proceeds to estate tax if the proceeds were paid to the decedent's estate or executor or if the decedent retained "incidents of ownership" in the life insurance policy.[141]

The Small Business Tax Revision Act of 1958[142] provided for payment of Federal estate tax on certain closely held businesses in installments over a 10-year period.[143]

Legislation from 1976 through 1980

In the Tax Reform Act of 1976,[144] Congress substantially revised estate and gift taxes by: (1) providing for a single unified rate structure for cumulative lifetime and deathtime transfers;[145] (2) providing an exemption in the form of a credit (called the "unified credit") which exempted $175,625 of transfers from tax when fully phased-in; (3) revising and lowering the unified rate structure such that the maximum rate of tax was 70 percent; (4) changing the income tax rules applicable to the disposition of inherited assets from a rule that only taxed post-death appreciation (i.e., the basis in the hands of the heir was "stepped-up" to its value on the date of the decedent's death) to one that provided that the heir's basis generally would be the same as its basis to the decedent (i.e., the decedent's basis in the property would "carryover" to be the basis to the heir); (5) providing a 100-percent marital deduction for the first $250,000 of property transferred to a surviving spouse; (6) changing the treatment of gifts made in contemplation of death from a rebuttable presumption that gifts made within three years of death would be subject to estate tax to a rule that subjects all gifts made within three years of death to the estate tax;[146] (7) providing that each spouse was rebuttably presumed to have contributed equally to the acquisition cost of jointly held property; (8) providing that a farm or other real property used in a closely held business could be valued at its "current use value" instead of its "highest and best use" value, so long as the heirs continued to so use the property for 15 years after the decedent's death;[147] (9) providing a limited deduction for bequests to children with no living parents (the so-called "orphan's deduction"); (10) providing a new transfer tax on

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[140] Revenue Act of 1948, 62 Stat. 110.
[141] This rule is now contained in section 2042 of present law.
[142] P.L. 85-566.
[143] This rule has been subsequently modified, and is now contained in section 6166 of present law.
[144] P.L. 94-455.
[145] These rules are contained in sections 2001 and 2501 of present law.
[146] This rule is now contained in sectin 2035 of present law.
[147] These rules are not contained in section 2032A of present law.

generation-skipping transfers basically equal to the additional estate or gift tax that the decedent's children would have paid if the property had passed directly to the children instead in a form where the children received only an income interest or power to control the enjoyment of the property; (11) providing statutory rules governing the disclaimer of gifts and bequests under which an unqualified, irrevocable refusal to accept any benefits from the gift or bequest generally within 9 months of the creation of the transferee's interest is not treated as a gift by the disclaiming individual;[148] and liberalized the provision which permits installment payment of estate tax on closely-held business by providing that only interest need be paid for the first four years after death and lenthening the period of installment an additional four years to 14 years.

In 1980, the "carryover basis" rule was retroactively repealed and replaced by the "stepped-up basis" rules that applied before the 1976 legislation.[149]

Legislation from 1981 through 1985

The Economic Recovery Act of 1981 ("1981 Act")[150] made the following changes to the estate and gift taxes: (1) increased the unified credit such that, when fully phased-in in 1987, it effectively exempted the first $600,000 of transfers from the unified estate and gift tax; (2) reduced the top unified estate and gift tax rate from 70 percent to 50 percent over a four-year period (1982-1985); (3) provided for an unlimited deduction for transfers to spouses and permitted such a deduction (the so-called "QTIP deduction") even where the donee spouse could not control disposition of the property after that spouse's death, so long as that spouse had an income interest in that property and that property was subject to that spouse's estate and gift tax;[151] (4) increased the annual gift tax exemption from $3,000 per year per donee to $10,000 per year per donee; (5) changed the presumption that each spouse equally provided for the acquisition cost of jointly held property to an irrebuttable presumption; (6) modified the "current use" valuation rules by shortening to 10 years the period that heirs who inherit farms or other real property used in a closely held business were required to so use the property, and by increasing the maximum reduction in the value of such property from $500,000 to $750,000; (7) repealed the so-called "orphan's deduction;" (8) delayed the effective date of the generation-skipping transfer tax, (9) further liberalized and simplified the rules which permit the installment payment of estate tax on closely-held businesses.

The Deficit Reduction Act of 1984: (1) delayed for three years the scheduled reduction of the maximum estate and gift tax rates (such that maximum rate remained at 55 percent until 1988); (2) eliminated the exclusion for interests in qualified pension plans; (3) provided rules for the gift tax treatment of below-market rate loans; and (4) extended the rules which permit the installment payment

[148] This rule is now contained in section 2518 of present law.
[149] Crude Oil Windfall Profits Act of 1980 (P.L. 96–223).
[150] P.L. 97-34.
[151] This rule in now contained in section 2056 of present law.

of estate taxes on closely-held businesses to certain holding companies.

1986 and subsequent legislation

The Tax Reform Act of 1986[152] substantially revised the tax on generation-skipping transfers by applying a single rate equal to the highest estate tax rate (i.e., 55 percent) to all generation skipping transfers in excess of $1 million and by broadening the definition of a generation-skipping transfer to include direct transfers from a grandparent to a grandchild (i.e., "direct skips").[152a]

The Omnibus Budget Reconciliation Act of 1987 made the following modifications: (1) provided special rules for so-called "estate freeze transactions" under which the person who engaged in such a transaction would be subject to estate tax on the value of such property; (2) provided a higher estate or gift tax rate on transfers in excess of $10 million to phase-out the unified credit and rate brackets lower than 55 percent; and (3) again delayed for five years the scheduled reduction in the estate and gift tax rates from 55 percent to 50 percent.

The Omnibus Budget Reconciliation Act of 1990 replaced the special rules for estate freeze transactions with a new set of rules that effectively subject to gift tax the full value of interests in property, unless retained interests in that property take certain specified forms.[153]

The maximum estate, gift, and generation-skipping transfer tax rate dropped to 50 percent on December 31, 1992, but the Omnibus Budget Reconciliation Act of 1993 restored the 55-percent top rate retoactively to January 1, 1993, and made that top rate permanent.[154]

Summary

Table 12 provides a summary of the annual gift tax exclusion, the exemption value of the unified credit, the threshold level of the highest statutory estate tax rate, and the highest statutory estate tax rate for selected years, 1977–1996.

[152] P.L. 99-514.
[152a] These rules are now contained in sections 2601 through 2654 of present law.
[153] These rules are contained in sections 2701 through 2704 of present law.
[154] P.L. 103-66.

Table 12.—Annual Gift Exclusion Amount, Exemption Value of Unified Credit for Taxable Transfers, Threshold Level of Highest Statutory Tax Rate, and Highest Statutory Tax Rate Applicable to Taxable Transfers, Selected Years, 1977–1996

Year	Annual gift exclusion single/ joint ($ dollars)	Exemption value of unified credit ($ dollars)	Threshold of highest statutory tax rate ($ millions)	Highest statutory tax rate (percent)
1977	3,000/6,000	120,667	5	70
1982	10,000/20,000	225,000	4	65
1983	10,000/20,000	275,000	3.5	60
1984	10,000/20,000	325,000	3	55
1985	10,000/20,000	400,000	3	55
1986	10,000/20,000	500,000	3	55
1987	10,000/20,000	600,000	3	55
1988	10,000/20,000	600,000	3	[1] 55
1990	10,000/20,000	600,000	3	[1] 55
1992	10,000/20,000	600,000	3	[1] 55
1994	10,000/20,000	600,000	3	[1] 55
1996	10,000/20,000	600,000	3	[1] 55

[1] Since 1987, the benefits of the graduated rate structure have been phased out at a 5-percent rate for estates between $10,000,000 and $21,040,000, creating an effective marginal tax rate of 60 percent for affected estates.

Source: Joint Committee on Taxation.

C. Description of Proposals

1. President's Fiscal Year 1998 Budget Proposal

The proposal would make several modifications to the installment payment provisions of section 6166. The proposal would increase the amount of value in a closely held business that would be eligible for the special low interest rate, from $1,000,000 to $2,500,000. Interest paid on the deferred estate tax would not be deductible for estate or income tax purposes, but the 4-percent rate would be reduced to 2 percent, and the deferred estate tax on any value of a closely held business in excess of $2,500,000 would be subject to interest at a rate equal to 45 percent of the usual rate applicable to tax underpayments.

The proposal also would expand the availability and benefits of the holding company exception to include partnerships that function as holding companies, and would clarify and expand the non-readily tradeable stock requirement to include non-publicly traded partnerships. In addition, an estate using the holding company exception (as modified by the proposal) would be able to take advantage of the five-year deferral and special 2-percent rate, thus providing the same relief to closely held businesses whether owned directly or through holding companies.

Finally, the proposal would authorize the Secretary of the Treasury to accept security arrangements in lieu of the special estate tax lien.

The proposal would apply to the estates of decedents dying after December 31, 1997. Estates that are deferring estate tax under current law could make a one-time election to use the lower interest rates and forgo the interest deduction.

2. The "Balanced Budget Act of 1995" (H.R. 2491, 104th Cong.) (the "BBA")[155]

Increase in estate and gift tax unified credit; indexing of certain other provisions

The BBA would have increased ratably the present-law unified estate and gift tax credit over a six-year period beginning in 1996, from an effective exemption of $600,000 to an effective exemption of $750,000. After 2001, the effective exemption amount of $750,000 would have been indexed annually for inflation.

The BBA also would have indexed annually for inflation the $10,000 annual exclusion for gifts, the $750,000 ceiling on special use valuation, the $1,000,000 generation-skipping transfer tax exemption, and the $1,000,000 ceiling on the value of a closely-held business eligible for the special 4-percent interest rate, beginning in 2001.

Estate tax exclusion for qualified family-owned businesses

The BBA would have provided special estate tax treatment for qualified "family-owned business interests" if such interests comprised more than 50 percent of a decedent's estate. Subject to certain requirements, the BBA would have excluded the first $1 million in value of qualified family-owned business interests from the decedent's estate and also would have excluded 50 percent of the value of qualified family-owned business interests between $1 million and $2.5 million. In general, a qualified family-owned business interest would be any nonpublicly-traded interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if ownership of the trade or business is held at least 50 percent by one family, 70 percent by two families, or 90 percent by three families, as long as the decedent's family owns at least 30 percent of the trade or business. To qualify for the beneficial treatment, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's death, and each qualified heir (or a member of the qualified heir's family) would be required to materially participate in the trade or business for at least five years of each eight-year period ending within ten years after the decedent's death.

The benefit of the exclusion for qualified family-owned business interests would be subject to recapture if, within 10 years of the decedent's death and before the qualified heir's death, one of the following "recapture events" occurs: (1) the qualified heir ceases to meet the material participation requirements; (2) the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified

[155] The Balanced Budget Act of 1995 ("BBA") was passed by the Congress in 1995, but was vetoed by President Clinton.

heir's family or through a qualified conservation contribution; (3) the principal place of business of the trade or business ceases to be located in the United States; or (4) the qualified heir loses U.S. citizenship. The portion of the reduction in estate taxes that is recaptured would depend upon the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business after the decedent's death. If the qualified heir (or his or her family members) materially participated in the trade or business after the decedent's death for less than six years, 100 percent of the reduction in estate taxes attributable to that heir's interest would be recaptured; if the participation was for at least six years but less than seven years, 80 percent of the reduction in estate taxes would be recaptured; if the participation was for at least seven years but less than eight years, 60 percent would be recaptured; if the participation was for at least eight years but less than nine years, 40 percent would be recaptured; and if the participation was for at least nine years but less than 10 years, 20 percent of the reduction in estates taxes would be recaptured. In general, there would be no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. As under present-law section 2032A, however, the 10-year recapture period could be extended for a period of up to two years if the qualified heir did not begin to use the property for a period of up to two years after the decedent's death.

The provision would have been effective with respect to the estates of decedents dying after December 31, 1995.

Reduction in estate tax for certain land subject to permanent conservation easement

The BBA would have provided that an executor could elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement that meets the following requirements: (1) the land must be located within 25 miles of a metropolitan area or a national park or wilderness area, or within 10 miles of an Urban National Forest; (2) the land must have been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution of a qualified real property interest had been granted by the transferor or a member of his or her family. For purposes of the BBA, preservation of a historically important land area or a certified historic structure would not qualify as a conservation purpose. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death would be a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Debt-financed property would not be eligible for the exclusion.

The exclusion amount would be calculated based on the value of the property after the conservation easement has been placed on the property. The exclusion from estate taxes would not extend to the value of any development rights retained by the decedent or donor, although payment for estate taxes on retained development rights could be deferred for up to two years, or until the disposition of the property, whichever is earlier.

The 40-percent exclusion from estate taxes for land subject to a qualified conservation easement (described above) could only be taken to the extent that the value of such land, plus the value of qualified family-owned business interests that qualify for the reduction in estate taxes, does not exceed $5 million.

If the value of the conservation easement is less than 30 percent of (1) the value of the land without the easement, reduced by (2) the value of any retained development rights, then the exclusion percentage would be reduced. The reduction in the exclusion percentage would be equal to two percentage points for each point that the above ratio falls below 30 percent.

The BBA also would have provided that the granting of a qualified conservation easement (as defined above) would not be treated as a disposition triggering the recapture provisions of section 2032A.

The provision would have been effective for decedents dying after December 31, 1995.

Modification of generation-skipping transfer tax for transfers to individuals with deceased parents

The BBA would have extended the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. For example, the exception would have applied to a transfer made by an individual (with no living lineal heirs) to a grandniece where the transferor's nephew or niece who is the parent of the grandniece is deceased at the time of the transfer.

In addition, the BBA would have extended the predeceased parent exception (as modified by the change in the preceding paragraph) to taxable terminations and taxable distributions, provided that the parent of the relevant beneficiary was dead at the earliest time that the transfer (from which the beneficiary's interest in the property was established) was subject to estate or gift tax. For example, where a trust was established to pay an annuity to a charity for a term for years with a remainder interest granted to a grandson, the termination of the term for years would not be a taxable termination subject to the GST tax if the grandson's parent (who is the son or daughter of the transferor) was deceased at the time the trust was created and the transfer creating the trust was subject to estate or gift tax.

The provision would have been effective for generation-skipping transfers occurring after December 31, 1994.

Estate tax recapture from cash leases of specially-valued property

The BBA would have provided that the cash lease of specially-valued real property by a lineal descendant of the decedent to a member of the lineal descendant's family, who continues to operate the farm or closely held business, would not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c).

The provision would have been effective for cash rentals after December 31, 1995.

Estate and gift tax simplification

The BBA also would have made a number of estate and gift tax simplification changes.

3. H.R. 525 (Mr. Crane and others) and H.R. 902 (Mr. Cox and others) [156]

These bills would repeal the Federal estate and gift tax and the Federal generation-skipping transfer tax fordecedents dying, gifts made, and generation-skipping transfers occurring after the date of enactment.

4. The "Family Business Protection Act" (Mr. McCrery and others)

Increase in estate and gift tax unified credit; new estate and gift tax rates

The proposal would increase ratably the present-law unified estate and gift tax credit over a five-year period beginning in 1997, from an effective exemption of $600,000 to an effective exemption of $1,000,000. The full $1,000,000 effective exemption would be available for decedents dying, and gifts made, after December 31, 2000. The proposal also would modify the existing estate and gift tax rate schedule.

Estate tax exclusion for qualified family-owned businesses

The proposal would provide special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate. Subject to certain requirements, the proposal would exclude the first $1,500,000 in value of qualified family-owned business interests from the decedent's estate and also would exclude 50 percent of the remaining value of qualified family-owned business interests. Beginning in 1998, the $1.5 million threshold would be indexed annually for inflation. In general, a qualified family-owned business interest would be any nonpublicly-traded interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if ownership of the trade or business is held at least 50 percent by one family, 70 percent by two families, or 90 percent by three families, as long as the decedent's family owns at least 30 percent of the trade or business. To qualify for the beneficial treatment, there must have been ownership and active management of the trade or business by the decedent (or a member of the decedent's family) for at least five of the eight years preceding the decedent's death, and there must be active management of the trade or business by each qualified heir (or a member of the qualified heir's family) for at least five years of each eight-year period ending within 10 years after the decedent's death.

The benefit of the exclusion for qualified family-owned business interests would be subject to recapture if, within 10 years of the decedent's death and before the qualified heir's death, one of the

[156] Several similar bills also have been introduced in both the House and the Senate.

following "recapture events" occurs: (1) the qualified heir ceases to meet the active management requirements; or (2) the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution. The portion of the reduction in estate taxes that is recaptured would depend upon the year in which the recapture event occurs. If the recapture event occurs in the first five years after the decedent's death, 100 percent of the reduction in estate taxes attributable to that heir's interest would be recaptured; if the recapture event occurs in the sixth year, 50 percent of the reduction in estate taxes would be recaptured; if the recapture event occurs in the seventh year, 40 percent of the reduction in estate taxes would be recaptured; if the recapture event occurs in the eighth year, 30 percent of the reduction in estate taxes would be recaptured; if the recapture event occurs in the ninth year, 20 percent of the reduction in estate taxes would be recaptured; and if the recapture event occurs in the tenth year, 10 percent of the reduction in estate taxes would be recaptured. In general, there would be no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. As under present-law section 2032A, however, the 10-year recapture period could be extended for a period of up to two years if the qualified heir did not begin to use the property for a period of up to two years after the decedent's death. A reduced 4-percent interest rate would apply to any recaptured taxes.

The provision would be effective with respect to the estates of decedents dying after December 31, 1996.

Index maximum reduction under special use valuation election [157]

Beginning in 1997, the proposal would index annually the $750,000 maximum reduction in the estate tax value of real property qualifying for an election under section 2032A, effective for decedents dying after December 31, 1996.

Reduction in estate tax for certain land subject to permanent conservation easement [158]

The proposal would provide that an executor could elect to exclude from the taxable estate the value of any land subject to a qualified conservation easement that meets the following requirements: (1) the land must be located within 50 miles of a metropolitan area or a national park or wilderness area; (2) the land must have been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution of a qualified real property interest has been granted by the transferor or a member of his or her family. For purposes of the proposal, preservation of a historically important land area or a certified historic structure would not qualify as a conservation pur-

[157] This proposal also was included in H.R. 64, introduced by Mr. Herger and Ms. Dunn on January 7, 1997.

[158] This proposal also was included in H.R. 195, the "American Farm and Ranch Protection Act," introduced on January 7, 1997, by Mr. Houghton and Mr. Cardin.

pose. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death would be a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Debt-financed property would not be eligible for the exclusion.

The exclusion amount would be calculated based on the value of the property after the conservation easement has been placed on the property. The exclusion from estate taxes would not extend to the value of any development rights retained by the decedent or donor, although payment for estate taxes on retained development rights may be deferred for up to two years, or until the disposition of the property, whichever is earlier.

Other provisions of the proposal would: (1) exclude a gift of land subject to a conservation easement from the Federal gift tax upon the same terms as pertain to the exclusion from estate taxes provided that the easement meets the standards listed above; (2) provide that the granting of a qualified conservation easement (as defined above) would not be treated as a disposition triggering the recapture provisions of section 2032A; and (3) allow a charitable deduction to taxpayers making a contribution of a permanent conservation easement on property where a mineral interest has been retained and surface mining is possible, but its probability is "so remote as to be negligible." Present law provides for a charitable deduction in such a case if the mining rights have been separated from the land prior to June 13, 1976. The proposal would provide that such a charitable deduction could be taken regardless of when the mining rights had been separated.

The provisions pertaining to conservation easements would apply to decedents dying after December 31, 1996.

Exclusion for certain historic property [159]

The proposal would allow an exemption from the estate tax for the value of any qualified historic property that would otherwise be included in a decedent's gross estate. To qualify under the proposal: (1) the property must be an historically important land area or a certified historic structure (within the meaning of Code section 170(h)(4)(A)(iv)); (2) a qualified conservation contribution (within the meaning of section 170(h)) of a qualified real property interest (as generally defined in section 170(h)(2)(C)) must have been granted to a charity (or other qualified organization) exclusively for conservation purposes; and (3) each person having an interest in the property must have signed a written agreement with a State historic preservation agency (or similar State agency) providing that the historic property will be open to the public for a period of at least 20 years after the decedent's death, and such agreement must be filed with the estate tax return.

The reduction in estate taxes resulting from the exclusion would be recaptured if, within the 20-year period, (1) any individual who signed the written agreement disposes of his or her interest in the property, unless the transferee agrees to be bound by the terms of the agreement, or (2) there is a violation of any provision of the

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[159] This proposal was also included in H.R. 1945 (104th Cong.), introduced on June 28, 1995, by Mr. Bateman and others.

agreement. The amount of recapture would be determined on a pro rata basis based on the number of months remaining in the 20-year period.

The provision would be effective for decedents dying after the date of enactment.

5. The "American Family Tax Relief Act" (S. 2) (Senator Roth and others)

Increase in estate and gift tax unified credit

The bill would increase ratably the present-law unified estate and gift tax credit over an eight-year period beginning in 1997, from an effective exemption of $600,000 to an effective exemption of $1,000,000. The full $1,000,000 effective exemption would be available for decedents dying, and gifts made, after December 31, 2003.

Estate tax exclusion for qualified family-owned businesses

The bill would provide special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate. Subject to certain requirements, the bill would exclude the first $1,500,000 in value of qualified family-owned business interests from the decedent's estate and also would exclude 50 percent of the remaining value of qualified family-owned business interests. In general, a qualified family-owned business interest would be any nonpublicly-traded interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if ownership of the trade or business is held at least 50 percent by one family, 70 percent by two families, or 90 percent by three families, as long as the decedent's family owns at least 30 percent of the trade or business. To qualify for the beneficial treatment, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's death, and each qualified heir (or a member of the qualified heir's family) would be required to materially participate in the trade or business for at least five years of each eight-year period ending within 10 years after the decedent's death.

The benefit of the exclusion for qualified family-owned business interests would be subject to recapture if, within 10 years of the decedent's death and before the qualified heir's death, one of the following "recapture events" occurs: (1) the qualified heir ceases to meet the material participation requirements; (2) the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution; (3) the principal place of business of the trade or business ceases to be located in the United States; or (4) the qualified heir loses U.S. citizenship. The portion of the reduction in estate taxes that is recaptured would depend upon the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business after the decedent's death. If the qualified heir (or his or her family members) materially participated in the trade or business after the decedent's death for less than six years, 100 percent of the reduction in estate taxes attributable to that heir's interest would be recaptured; if the participation was for at least six years but less than seven years, 80 percent of the reduction in estate taxes would be recaptured; if the participation was for at least seven years but less than eight years, 60 percent would be recaptured; if the participation was for at least eight years but less than nine years, 40 percent would be recaptured; and if the participation was for at least nine years but less than 10 years, 20 percent of the reduction in estates taxes would be recaptured. In general, there would be no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. As under present-law section 2032A, however, the 10-year recapture period could be extended for a period of up to two years if the qualified heir did not begin to use the property for a period of up to two years after the decedent's death.

The bill would apply to decedents dying, and gifts made, after December 31, 1996.

Installment payments of estate tax attributable to closely held businesses

The bill would extend the period for which Federal estate tax installments could be made under section 6166 to a maximum period of 24 years. If the election were made, the estate would pay only interest for the first four years, followed by up to 20 annual installments of principal and interest. Under the bill, there would be no interest imposed on the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely held business. The interest rate imposed on the amount of deferred estate tax attributable to the value of the closely held business in excess of $1,000,000 would remain as under present law (i.e., the rate applicable to underpayments of tax under section 6621, which is the Federal short-term rate plus 3 percentage points).

The bill would apply to decedents dying, and gifts made, after December 31, 1996.

D. Background and Economic Analysis

1. Background Data Relating to Estate and Gift Taxation

Estates subject to the estate tax

Table 13 details the percentage of decedents subject to the estate tax for selected years since 1935. The percentage of decedents liable for the estate tax grew throughout the postwar era reaching a peak in the mid-1970s. The substantial revision to the estate tax in the mid-1970s[160] and subsequent further modifications in 1981 reduced the percentage of decedents liable for the estate tax to less than one percent in the late 1980s. Since that time, the percentage of decedents liable for the estate tax has gradually increased.

[160] See description of changes made to the estate tax in 1976 in Part IV.B., above.

Table 13.—Number of Taxable Estate Tax Returns Filed as a Percentage of Adult Deaths, Selected Years, 1935–1995

Year	Deaths	Taxable estate tax returns filed [1]	
		Number	Percent of deaths
1935	1,172,245	8,655	0.74
1940	1,237,186	12,907	1.04
1945	1,239,713	13,869	1.12
1950	1,304,343	17,411	1.33
1955	1,379,826	25,143	1.82
1961	1,548,665	45,439	2.93
1966	1,727,240	[2] 67,404	3.90
1970	1,796,940	[2] 93,424	5.20
1973	1,867,689	[2] 120,761	6.47
1977	1,819,107	[2] 139,115	7.65
1982	1,897,820	[2,3] 41,620	2.19
1983	1,945,913	[2,3] 35,148	1.81
1984	1,968,128	[2,3] 31,507	1.60
1985	2,086,440	[2,3] 30,518	1.46
1986	2,105,361	23,731	1.13
1987	2,123,323	21,335	1.00
1988	2,167,999	18,948	0.87
1989 [4]	2,150,466	20,856	0.97
1990 [4]	2,148,463	23,215	1.08
1991 [4]	2,169,518	24,897	1.15
1992 [4]	2,175,613	27,187	1.25
1993 [4]	2,268,553	27,506	1.21
1994 [4]	2,278,994	31,918	1.40
1995 [4]	[5] 2,312,180	31,564	1.37

[1] Estate returns need not be filed in the year of the decedent's death.

[2] Not strictly comparable with pre-1966 data. For later years, the estate tax after credits was the basis for determining taxable returns. For prior years, the basis was the estate tax before credits.

[3] Although the filing requirement was for gross estates in excess of $225,000 for 1982 deaths, $275,000 for 1983 deaths, and $325,000 for 1984 deaths, the data are limited to gross estates of $300,000 or more.

[4] Taxable estate data from 1989 on from Internal Revenue Service, *Statistics of Income.*

[5] Preliminary.

Sources: Joseph A. Pechman, *Federal Tax Policy* (Washington Brookings Institution), 1987; Internal Revenue Service, *Statistics of Income*; and U.S. National Center for Health Statistics.

The increasing percentage of decedents liable for estate tax in the period from 1940 through the mid-1970s and the similar increasing percentages since 1989 are the result of the interaction of three factors: a fixed nominal exemption; the effect of price inflation on asset values; and real economic growth. The amount of wealth exempt from the Federal estate tax always has been expressed at a fixed nominal value. If the general price level in the economy rises from one year to the next and asset values rise to reflect this inflation, the "nominal" value of each individual's wealth will increase. With a fixed nominal exemption, annual increases in the price level will imply that more individuals will have a nominal wealth that exceeds the tax threshold. Alternatively stated, inflation diminishes the real, inflation-adjusted, value of wealth that is exempted by a nominal exemption. Thus, even if no one individual's real wealth increased, more individuals would be subject to the estate tax. This interaction between inflation and a fixed nominal exemption largely explains the pattern in Table 13.[161] The fixed nominal exemption was increased effective for 1977 and again between 1982 and 1987. Prior to 1977 and subsequent to 1987, the exemption was unchanged while the economy experienced general price inflation.

However, even if the exemption were modified annually to reflect general price inflation, one would still expect to see the percentage of decedents liable for estate tax rise because of the third factor, real growth. If the economy is experiencing real growth per capita, it must be accumulating capital.[162] Accumulated capital is the tax base of the estate tax. Thus, real growth can lead to more individuals having real wealth above any given fixed *real* exempt amount.[163]

Indexing the exemption for inflation is equivalent to creating a fixed real exemption rather than a fixed nominal exemption. Had the $600,000 effective exemption created by the 1981 Act (effective for 1987) been indexed for inflation subsequent to 1987, its nominal value today would be approximately $838,000. Had the $175,625 effective exemption created by the 1976 Act (effective for 1982) been indexed for inflation subsequent to 1982, its nominal value today would be approximately $289,000.

Revenues from the estate, gift, and generation skipping taxes

Table 14 provides summary statistics of the estate and gift tax over the past 20 years. Total estate and gift receipts include taxes paid for estate, gift, and generation skipping taxes as well as payments made as the result of IRS audits.

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[161] The 1988 percentage of decedents liable for estate tax of 0.87 may overstate the nadir achieved by the increase in the unified credit to an exemption equivalent amount of $600,000. This is because the 1981 legislation also increased the marital exemption to an unlimited exemption. See Part IV.B., above. An increase in the marital exemption would be expected to reduce the percentage of decedents liable for the estate tax, both permanently and during a temporary period following the increase. The permanent effect results from some married couples having neither spouse liable for estate tax. The temporary reduction in the percentage of decedents liable for estate tax arises as follows. A married couple may have sufficient assets to be subject to the estate tax. During the transition period in which husbands and wives first take advantage of the unlimited marital exemption, the number of decedents liable for estate tax falls as the first spouse to die takes advantage of the expanded marital deduction, despite the fact that the surviving spouse subsequently dies with a taxable estate. In the long run, the number of new couples utilizing the unlimited marital deduction may be expected to approximately equal the number of surviving spouses becoming taxable after their decedent spouse had claimed the unlimited marital deduction.

[162] The following analysis assumes that the capital accumulated is physical or business intangible capital. Real per capita GNP could grow if individuals accumulated more knowledge and skills, or what economists call "human capital." Accumulation of human capital unaccompanied by the accumulation of physical or business intangible capital would not necessarily lead to increasing numbers of decedents becoming liable for estate tax.

[163] This analysis assumes that the capital accumulation is held broadly. If the growth in the capital stock were all due to a declining number of individuals doing the accumulating, then the distribution of wealth would be becoming less equal and real growth could be accompanied by a declining percentage of decedents being liable for estate tax.

Table 14.—Revenue from the Federal Estate, Gift, and Generation Skipping Transfer Taxes, Selected Years, 1940–1996

Year	Revenue ($ millions)	Percentage of total Federal receipts
1940	357	6.9
1945	638	1.4
1950	698	1.9
1955	924	1.4
1960	1,606	1.7
1965	2,716	2.3
1970	3,644	1.9
1975	4,611	1.7
1976	5,216	1.7
1977	7,327	2.1
1978	5,285	1.3
1979	5,411	1.2
1980	6,389	1.2
1981	6,787	1.1
1982	7,991	1.3
1983	6,053	1.0
1984	6,010	0.9
1985	6.422	0.9
1986	6,958	0.9
1987	7,493	0.9
1988	7,594	0.8
1989	8,745	0.9
1990	11,500	1.12
1991	11,138	1.06
1992	11,143	1.02
1993	12,577	1.09
1994	15,225	1.21
1995	15,087	1.12
1996	17,189	1.18

Sources: Joint Economic Committee, *The Federal Tax System: Facts and Problems,* 1964; Joseph A. Pechman, *Fedeal Tax Policy* (Washington: Brookings Institution), 1987; Internal Revenue Service, *Statiscs of Income Bulletin,* Fall 1996, and U.S. Office of Management and Budget, *Budget of the United States Government Fiscal Year 1997,* and prior years.

Since 1993, estate and gift receipts have been averaging double digit rates of growth. There are four possible reasons for the rapid growth in these receipts. First, because neither the amount of wealth exempt from the estate and gift tax or the tax rates are indexed, as explained above, an increasing number of persons are becoming subject to estate and gift taxes. Second, the tremendous increase in value in the stock market over the past three years will both increase the value of estates that would have already been taxable, and increase the number of estates that will be taxable. For example, the Dow Jones Industrial Average ended 1993 at approximately 3750, and ended 1996 at approximately 6500. On average, one-third of the wealth in taxable estates consists of publicly traded stocks. Because the value of this component of wealth has nearly doubled during the past three years, one would expect brisk growth in estate tax receipts from this alone. Third, while the overall population of the United States is growing at about a 1 percent annual rate, the number of persons aged 85 and older is growing at a rate of almost 3.5 percent annually. This also should increase the number of estate tax returns filed. Finally, the unlimited marital deduction included in the 1981 Act delayed the payment of estate tax, in most cases, until the surviving spouse died. On average, spouses survive their mates by about ten years. Therefore, during the decade of the 1990s, an increase in estate tax receipts is expected as the result of first-spouse deaths during the 1980s that used the unlimited marital deduction.

Table 15 shows the Joint Committee on Taxation staff present-law estimate of revenues from the estate, gift, and generation skipping taxes for fiscal years 1997-2007. These estimates are based on the baseline forecast for estate, gift, and generation skipping taxes supplied the Congressional Budget Office. Table 15 reports the Joint Committee on Taxation staff estimates of annual taxable estates and calculates the percentage of all deaths that taxable estates will represent.

Table 15.—Projections of Taxable Estates and Receipts from Estate, Gift, and Generation Skipping Transfer Taxes, 1997–2007

Fiscal year	Number of taxable estates	Receipts ($ billions)	Taxable estates as a percentage of all deaths [1]
1997	37,200	19.2	1.66
1998	40,100	20.6	1.75
1999	43,100	21.9	1.86
2000	46,000	23.3	1.97
2001	49,300	24.7	(2)
2002	43,000	26.2	(2)
2003	56,700	27.8	(2)
2004	61,100	29.5	(2)
2005	65,100	31.4	2.64
2006	69,000	33.3	(2)
2007	73,200	35.3	(2)

[1] This column divides the estimate of taxable estates by U.S. Census Bureau's projections of death rates as reported in Table 4 of U.S. Department of Commerce, Economics and Statistics Administration, Bureau of the Census, *Statistical Abstract of the United States, 1995.*

[2] Not available, Census projections beyond 2000 are only reported for every fifth year.

Sources: Joint Committee on Taxation staff calculations.

2. Comparison of Transfer Taxation in the United States with Transfer Taxation Abroad

Among developed countries, an inheritance tax is more common than the type of estate tax that is imposed in the United States. An inheritance tax generally is imposed upon the amount of wealth the transferee or donee receives rather than on the total wealth of the transferor. That is, the funds the heir receives in a bequest determines the tax imposed. The United States also imposes a generation-skipping tax in addition to any estate or gift tax liability on certain transfers to generations two or more younger than that of the transferee. This effectively raises the marginal tax rates on affected transfers. Countries that impose an inheritance tax do not have such a separate tax but may impose higher rates of inheritance tax on bequests that skip generations. Among developed countries, Australia and Canada impose neither an estate tax nor an inheritance tax.[164]

Because the U.S. estate and gift tax exempts transfers between spouses, provides an effective additional exemption of $600,000 through the unified credit, and exempts $10,000 of gifts per year per donee, the United States may have a larger exemption (a larger

[164] For a survey of the transfer tax systems of 28 countries see Joint Committee on Taxation, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation*(JCS-17-95), June 1, 1995, pp. C-1 through C-17. In Australia the transferee receiving assets with accrued capital gains transferred at death retains the transferor's basis in the assets (carryover basis). In Canada, gains accrued on assets held by a taxpayer at the time of his or her death are treated as realized and taxable as income to the taxpayer. Assets transferred to a spouse are untaxed but retain the decedent spouse's basis (carryover basis).

zero-rate tax bracket) than many other developed countries.[165] However, because most other countries have inheritance taxes, the total exemption depends upon the number and type of beneficiaries. While the effective exemption may be larger, with the exception of transfers to spouses which are untaxed, marginal tax rates on taxable transfers in the United States generally are greater than those in other countries. This is particularly the case when comparing transfers to close relatives, who under many inheritance taxes face lower marginal tax rates than do other beneficiaries. On the other hand, the highest marginal tax may be applied at a greater level of wealth transfer than in other countries. It is often difficult to make comparisons between the U.S. estate tax and countries with inheritance taxes because the applicable marginal tax rate depends on the pattern of gifts and bequests.

It is difficult to assess the extent to which the practice of any of the foreign transfer taxes is comparable to the practice of transfer taxation in the United States. For example, in the United States, transfers of real estate generally are valued at their full and fair market value. In Japan, real estate is assessed at less than its fair market value. Land is assessed for inheritance tax purposes according to a valuation map known as *Rosen Ka*. The *Rosen Ka* values range from 25 to 80 percent of fair market value.[166] It is also unclear to what extent transferors may be able to exploit legal loopholes under the various systems imposed by other countries. Again, using Japan as an example, prior to 1988, a transferor could reduce inheritance tax liability by adopting children to increase the number of legal heirs.[167] Such adoptees of convenience would receive nominal compensation for agreeing to be an adoptive child. The larger the number of children, the greater the total exemption for inheritance taxes in Japan, even if not all children receive a bequest. This legal loophole was said to be widely recognized and exploited by wealthy families.[168]

Table 16 compares total revenue collected by OECD countries from estate, inheritance, and gift taxes to total tax revenue and to gross domestic product (GDP) to attempt to compare the economic significance of wealth transfer taxes in different countries. Among the OECD countries, Belgium, Denmark, France, Greece, and Japan collect more such revenue as a percentage of GDP than does the United States. Switzerland and the Netherlands collect modestly less revenue from such taxes as a percentage of GDP than does the United States. The remaining 15 countries collect substantially less revenue from such taxes as a percentage of GDP than does the United States.

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165 JCT, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation.*

166 Thomas A. Barthold and Takatoshi Ito, "Bequest Taxes and Accumulation of Household Wealth: U.S.-Japan Comparison," in Takatoshi Ito and Anne O. Kreuger (eds.), *The Political Economy of Tax Reform* (Chicago: The University of Chicago Press), 1992, pp. 250-251.

167 Adoption by another did not cause an adoptee to lose his or her legal right to be an heir of his or her biological parents.

168 Barthold and Ito, "Bequest Taxes and Accumulation of Household Wealth," p. 249.

Table 16.—Revenue from Estate, Inheritance and Gift Taxes as a Percentage of Total Tax Revenue and GDP in OECD Countries, 1992

Country	Percentage of total tax revenue	Percentage of GDP
Australia	0.000	0.000
Austria	0.182	0.079
Belgium	0.735	0.334
Canada	0.002	0.001
Denmark	0.555	0.274
Finland	0.456	0.214
France	0.929	0.405
Germany	0.253	0.100
Greece	1.039	0.421
Iceland	0.216	0.072
Ireland	0.304	0.112
Italy	0.138	0.058
Japan	2.006	0.590
Luxembourg	0.320	0.155
Netherlands	0.526	0.247
New Zealand	0.292	0.105
Norway	0.191	0.089
Portugal	0.252	0.083
Spain	0.366	0.131
Sweden	0.166	0.083
Switzerland	0.854	0.264
Turkey	0.111	0.026
United Kingdom	0.584	0.206
United States	0.907	0.267

Note.—Data not directly comparable to data reported in Table 14. The OECD attempts to collect standardized data across member countries. Therefore data in OECD reports for the United States may not perfectly correspond to data as reported by OMB.

Source: Organization for Economic Cooperation and Development, *Revenue Statistics of OECD Member Countries, 1965–1993* (Paris: OECD), 1994.

The United States is a wealthy country, with higher average household wealth than most of the countries surveyed. While exemption levels are higher in the United States than most other countries, a significant amount of accumulated wealth still may be subject to estate and gift taxation as compared to the other countries. The data in Table 16 do not reveal the extent to which estate, inheritance, and gift taxes fall across different individuals within each country. In the United States, as reported in Table 13, above, of the 2.18 million deaths in 1992, only 27,187 or 1.25 percent of decedents, gave rise to any estate tax liability. Similar data were not available for the other countries in this survey.

3. Economic Issues Related to Transfer Taxation

Taxes on income versus taxes on wealth

Income taxes, payroll taxes, and excise and other consumption taxes generally tax economic activity as it occurs. Income and consumption represent ongoing, current economic activity by the taxpayer.[169] Accumulated wealth, on the other hand, does not correspond to any ongoing, current economic activity.[170] Wealth depends upon previous economic activity either by the current wealth holder or other individuals. For example, current wealth can result from accumulated saving from income or from bequests received.

Taxes on wealth are not directly comparable to taxes on income. Because wealth is the accumulation of flows of saving over a period of years, taxes on wealth are not directly comparable to taxes on income or consumption which may represent only current, rather than accumulated, economic activity. For example, assume that a taxpayer receives wage income of $10,000 per year, saves all of this income, and the savings earn an annual return of 5 percent. At the end of five years, the accumulated value of the taxpayer's investments would be $58,019. Assume that the wealth is transferred at the end of the fifth year. If a 10-percent tax were imposed on wage income, one would conclude that a burden of $1,000 was imposed annually. If a 10-percent tax were imposed on the transfer of wealth, one would conclude that a burden of $5,801.90 was imposed at the end of the fifth year. If, after paying the wage tax, the taxpayer had invested the remaining $9,000 each year to earn 5 percent, the taxpayer's holding would be $52,217.10 at the end of five years. This is the same value that would remain under the wealth tax ($58,019.00 less $5,801.90). Thus, it is misleading to say that the burden of the wage tax is $1,000 in each year while the burden of the transfer tax is $5,801.90 in the fifth year.

Wealth taxes, saving, and investment

Taxes on accumulated wealth are taxes on the stock of capital held by the taxpayer. As a tax on capital, issues similar to those that arise in analyzing any tax on the income from capital arise. In particular, there is no economic consensus on the extent to which the incidence of taxes on the income from capital is borne

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169 Economists call income and consumption "flow" concepts. In simple terms, a flow can only be measured by reference to a unit of time. Thus, one refers to a taxpayer's annual income or monthly consumption expenditures.

170 Economists call wealth a "stock" concept. A stock of wealth, such as a bank account, may generate a flow of income, such as annual interest income.

by owners of capital in the form of reduced returns or whether reduced returns cause investors to save less and provide less capital to workers, thereby reducing wages in the long run. A related issue is to what extent individuals respond to increases (decreases) in the after-tax return to investments by decreasing (increasing) their saving. Again there is no census in either the empirical or theoretical economics literature regarding the responsiveness of saving to after-tax returns on investment.[171]

Some economists believe that an individual's bequest motives are important to understanding saving behavior and aggregate capital accumulation. If estate and gift taxes alter the bequest motive, they may change the tax burdens of taxpayers other than the decedent and his or her heirs. It is an open question whether the bequest motive is an economically important explanation of taxpayer saving behavior and level of the capital stock. For example, theoretical analysis suggests that the bequest motive may account for between 15 and 70 percent of the United States' capital stock.[172] Others question the importance of the bequest motive in national capital formation.[173] Nor has direct empirical analysis of the existence of a bequest motive led to a consensus.[174] Theoretically, it is an open question whether estate and gift taxes encourage or discourage saving and there has been no empirical analysis of this specific issue. By raising the cost, in terms of taxes, of leaving a bequest, potential transferors may be discouraged from accumulating the assets necessary to make a bequest. On the other hand, some individuals purchase additional life insurance in order to have sufficient funds to pay the estate tax without disposing of other assets in their estate.

Regardless of any potential effect on aggregate saving, the transfer tax system may affect the composition of investment. In particular, some observers note that the transfer tax system may impose special cash flow burdens on small or family-owned busi-

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[171] For a more detailed discussion of the incidence of taxes on the income from capital and the responsiveness of saving to after-tax rate of returns, see Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* (JCS-7-93), June 14, 1993, pp. 44-46.

[172] See, Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy*, 89, August, 1981. Also see, Laurence J. Kotlikoff, "Intergenerational Transfers and Savings," *Journal of Economic Perspectives*, 2, Spring, 1988. For discussion of these issues in the context of wealth transfer taxes see, Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal*, 45, June, 1992. For recent attempts to calculate the share of the aggregate capital stock attributable to the bequest motive, see Barthold and Ito, "Bequest Taxes and Accumulation of Household Wealth," and William G. Gale and John Karl Scholz, "Intergenerational Transfers and the Accumulation of Wealth," *Journal of Economic Perspectives*, 8, Fall 1994, pp. 145-160. Gale and Scholz estimate that 20 percent of the nation's capital stock can be attributed to "intentional transfers" (including inter vivos transfers, life insurance, and trusts) and another 30 percent can be attributed to bequests, whether planned or unplanned.

[173] Franco Modigliani, "The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth," *The Journal of Economic Perspectives*, 2, Spring, 1988. In this article, Modigliani argues that 15 percent is more likely an upper bound.

[174] See, B. Douglas Bernheim, "How Strong Are Bequest Motives? Evidence Based on Estimates of the Demand for Life Insurance and Annuities," *Journal of Political Economy*, 99, October 1991, pp. 899-927. Bernheim finds that social security annuity benefits raise life insurance holdings and depress private annuity holdings among elderly individuals. He interprets this as evidence that elderly individuals choose to maintain a positive fraction of their resources in bequeathable forms. For an opposing finding, see Michael D. Hurd, "Savings of the Elderly and Desired Bequests," *American Economic Review*, 77, June 1987, pp. 298-312. Hurd concludes that "any bequest motive is not an important determinant of consumption decisions and wealth holdings....Bequests seem to be simply the result of mortality risk combined with a very weak market for private annuities" (p. 308).

nesses. They note that if a family has a substantial proportion of its wealth invested in one enterprise, the need to pay estate taxes may force heirs to liquidate all or part of the enterprise or to encumber the business with debt to meet the estate tax liability. If the business is sold, while the assets generally do not cease to exist and remain a productive part of the economy, the share of business represented by small or family-owned businesses may be diminished by the estate tax. If the business borrows to meet estate tax liability, the business's cash flow may be strained. There is some evidence that many businesses may be constrained by the capital markets in the amount of funds they can borrow. If they are so constrained, they may reduce the amount of investment they undertake, to the detriment of the economy at large.[175] Undercapitalization may be prevalent among small businesses. A recent study suggests that reduction in estate taxes may have a positive effect on an entrepreneur's survival.[176]

Others argue that potential deleterious effects on investment by small or family-owned businesses is limited. They note that simple tax planning can create an effective exemption of $1.2 million dollars and that other legitimate tax planning can reduce the burden on such enterprises. Some have argued that returns report a small fraction of the value of decedents' estates.[177]

Wealth taxes and labor supply

As people become wealthier, they generally choose to consume more leisure time. Some, therefore, suggest that, by reducing the potential wealth of heirs, transfer taxes may have an effect on labor supply. Over 100 years ago, Andrew Carnegie opined that "the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would..." [178] While in theory increases in wealth should reduce labor supply, empirically economists have not found strong support for this proposition.[179]

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[175] Steven M. Fazzari, R. Glenn Hubbard, and Bruce C. Petersen, "Financing Constraints and Corporate Investment," *Brookings Papers on Economic Activity*, 1988, pp. 141-195.

[176] Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "Sticking It Out: Entrepreneurial Survival and Liquidity Constraints," *Journal of Political Economy*, 102, February 1994, pp. 53-75. Holtz-Eakin, Joulfaian, and Rosen study the effect of receipt of an inheritance on whether an entrepreneur's business survives rather than whether an on-going business taxed as an asset in an individual's estate survives. They find that "the effect of inheritance on the probability of surviving as an entrepreneur is small but noticeable: a $150,000 inheritance raises the probability of survival by about 1.3 percentage points," and "[i]f enterprises do survive, inheritances have a substantial impact o their performance: the $150,000 inheritance ... is associated with a nearly 20 percent increase in an enterprise's receipts" (p.74).

These results do not necessarily imply that the aggregate economy is made better off by receipt of inheritances. Survival of the entrepreneur may not be the most highly valued investment that could be made with the funds received.

[177] See George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Tax Avoidance*, (Washington, D.C.: The Brookings Institution), 1979. Also, see B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in Lawrence H. Summers (ed.), *Tax Policy and the Economy*, 1, (Cambridge, Mass.: The MIT Press), 1987; and Alicia H. Munnell with Nicole Ernsberger, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review*, November/December 1988. These studies pre-date the enactment of chapter 14 of the Internal Revenue Code. The purpose of chapter 14 is to improve reporting of asset values in certain transfers.

[178] Andrew Carnegie, "The Advantages of Poverty," in *The Gospel of Wealth and Other Timely Essays*, Edward C. Kirkland (ed.), (Cambridge, MA: The Belknap Press of Harvard University Press), 1962, reprint of Carnegie from 1891.

[179] For a review of this issue, see John Pencavel, "Labor Supply of Men: A Survey," in Orley Ashenfelter and Richard Layard (eds.), *Handbook of Labor Economics, vol. I*, (New York, NY: North-Holland Publishing Co.) 1986. For a direct empirical test of what some refer to as the "Carnegie Conjecture," see Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "The

Wealth taxes, the distribution of wealth, and fairness

Some suggest that, in addition to their role in producing Federal revenue, the transfer taxes may help prevent an increase in the distribution of wealth. There are relatively few analyses of the distribution of wealth holdings.[180] Conventional economic wisdom holds that the Great Depression of the 1930s and the second world war substantially reduced the concentration of wealth in the United States, and that there has been no substantial change in the succeeding decades. Most analysts assign no role to tax policy in the reduction in wealth concentration which occurred between 1930 and 1945. Nor has any analyst been able to quantify what role tax policy might have played since the second world war.[181]

Others note that the income tax does not tax all sources of income. They suggest that by serving as a "backstop" for income that escapes income taxation, the transfer taxes may help promote overall fairness of the U.S. tax system. Others counter that to the extent that much wealth was accumulated with after-(income)-tax dollars, as an across-the-board tax on wealth, transfer taxes, tax more than just those monies that may have escaped the income tax. In addition, depending upon the incidence of such taxes, it is difficult to make an assessment regarding the transfer taxes' contribution to the overall U.S. tax system.

Even if transfer taxes are believed to be borne by the owners of the assets, an additional conceptual difficulty is whether the tax is borne by the generation of the transferor or the generation of the transferee. The design of the gift tax illustrates this conceptual difficulty. A tax is assessed on the transferor for taxable gifts. Assume, for example, a mother makes a gift of $1 million to her son and incurs a gift tax liability of $500,000. From one perspective, the gift tax could be said to have reduced the mother's current economic well-being by $500,000. However, it is possible that, in the absence of the gift tax, the mother would have given her son $1.5 million, so that the gift tax has reduced the son's economic well-being by $500,000. It also is possible that the economic well-being of both was reduced. Of course, distinctions between the donor and donee generations may not be important to assessing the fairness

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Carnegie Conjecture: Some Empirical Evidence," *Quarterly Journal of Economics*, 108, May 1993, pp. 413-435. Holtz-Eakin, Joulfaian, and Rosen assess the labor force participation of families that receive an inheritance. They find that "the likelihood that a person decreases his or her participation in the labor force increases with the size of the inheritance received. For example, families with one or two earners who received inheritances above $150,000 [in 1982-1985 constant dollars] were about three times more likely to reduce their labor force participation to zero than families with inheritances below $25,000. Moreover, ...high inheritance families experienced lower earnings growth than low inheritance families, which is consistent with the notion that inheritance reduces hours of work" (pp.432-433).

[180] For some exceptions, see Martin H. David and Paul L. Menchik, "Changes in Cohort Wealth Over a Generation," *Demography*, 25, August 1988; Paul L. Menchik and Martin H. David, "The Effect of Income Distribution on Lifetime Savings and Bequests," *American Economic Review*, 73, September 1983; and Edward N. Wolff, "Estimate of Household Wealth Inequality in the U.S., 1962-1983," *The Review of Income and Wealth*, 33, September 1987.

[181] See Michael K. Taussig, "Les inegalities de patrimoine aux Estatis-Unis," in Kessler, Masson, Strauss-Khan (eds.) *Accumulation et Repartition des Patrimoines*. Taussig estimates shares of wealth held by the top 0.5 percent of wealth holders in the United States for various years between 1922 and 1972. Wolf, in "Estimate of Household Wealth Inequality in the U.S., 1962-1983," does not attribute any movements in wealth contribution directly to tax policy, but rather to the changes in the relative values of housing and corporate stock.

of transfer taxes if both the donor and donee have approximately the same income.[182]

[182] Researchers have found that the correlation of income between parents and children is less than perfect. For analysis of the correlation of income among family members across generations, see Gary R. Solon, "Intergenerational Income Mobility in the United States," *American Economic Review*, 82, June 1992, and David J. Zimmerman, "Regression Toward Mediocrity in Economic Stature," *American Economic Review*, 82, June 1992.